06-Nov-2019

Cars.com, Inc. (CARS)

Q3 2019 Earnings Call

CORPORATE PARTICIPANTS

Jandy Tomy
Vice President-Investor Relations & Treasury, Cars.com, Inc.

T. Alex Vetter
President, Chief Executive Officer & Director, Cars.com, Inc.

Becky A. Sheehan
Chief Financial Officer, Cars.com, Inc.

OTHER PARTICIPANTS

Tom White
Analyst, D.A. Davidson Companies

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Lee Krowl
Analyst, B. Riley FBR, Inc.

Daniel Powell
Analyst, Goldman Sachs & Co. LLC

Marvin Fong
Analyst, BTIG LLC

Nicholas Jones
Analyst, Citigroup Global Markets, Inc.

Steve Dyer
Analyst, Craig-Hallum Capital Group LLC

Douglas Middleton Arthur
Analyst, Huber Research Partners LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the Cars.com's Third Quarter 2019 Earnings Conference Call. Hosting the call this morning is Alex Vetter, Chief Executive Officer; and Becky Sheehan, Chief Financial Officer. This call is being recorded and a live webcast can be found at investor.cars.com. A replay of the webcast will be available at this website until November 20, 2019. A copy of the accompanying slides can be found on the Cars.com IR website. Following the presentation, there will be a question-and-answer session with Alex and Becky.

I'd now like to turn the call over to Jandy Tomy, Vice President of Investor Relations. Please go ahead.

Jandy Tomy
Vice President-Investor Relations & Treasury, Cars.com, Inc.

Good morning, everyone, and welcome to our third quarter 2019 earnings conference call. Before I turn the call over to Alex, I'd like to draw your attention to our forward-looking statements, and the description and definition of our non-GAAP financial measures, which can be found in our presentation. We will be discussing certain non-GAAP financial measures today, including adjusted EBITDA, adjusted EBITDA margin, adjusted net income, and free cash flow. Reconciliations of these non-GAAP measures to the most directly comparable GAAP measure can be found in the financial tables included with our earnings press release and in the Appendix of the presentation.

For more information, please refer to the risk factors included in our SEC filings, including those in our annual, quarterly, and current reports. Cars.com assumes no obligation to update any forward-looking statements or information as of their respective dates.

And at this time, I'd now like to turn the call over to Alex.

T. Alex Vetter
President, Chief Executive Officer & Director, Cars.com, Inc.

Thank you, Jandy. Good morning, everyone, and welcome to our conference call for the third quarter 2019. On this morning's call, I'll be discussing our third quarter business performance, and then hand the call over to Becky, who will discuss our financial results.

Our third quarter results were in line with expectations that we laid out on our last call. There are a few highlights that I'd like to discuss today. First, we completed our final affiliate market conversions, which gives us complete control over our entire customer network. With our affiliate sales model now behind us, our sales team is able to support dealers in these markets directly, and more effectively increase our sales and service in these territories.

Second, we took over as the number one player in SEO, which reinforces the strength of our brand and demonstrates our technical sophistication and validates our product strategy to deliver high-quality content.

Third, this quarter we announced a partnership with General Motors, which opens the door for us to sell our website solutions to over 4,000 new dealers across the country, and this creates more opportunities to sell a broader set of products and solutions.

And lastly, we achieved these milestones while generating significant operational efficiencies, most notably our sales and tech transformations.

As we discussed on our last earnings call, we are further along with dealer retention and cancellation rates, which have stabilized. Our investments in product and audience are improving value delivery for our customers, and we believe these investments will yield positive results moving forward.

Importantly, with the affiliate conversions now behind us, our entire sales team is in control and focused on growth across all markets. I'm pleased to report that we delivered a strong October, with nearly 100 net new dealer subscriptions. In fact, it was our second highest gross sales month in over two years.

Our dealer customer decline in Q3 was due to the declines in both direct and affiliate markets. Cancellation rates in affiliate markets were higher than direct, emphasizing the importance of early conversions to stop the heightened attrition experienced during periods when those markets were not under our control. The declines in the third quarter were partially offset by the growth in solutions-only customers.

The improvement in dealer count is more of a marathon than a sprint, and the initiatives around traffic and lead growth, product innovation, sales effectiveness, like our turnaround with SEO, takes time, but ultimately makes our subscriptions much stickier. We're using the same playbook that was successful in reversing our traffic declines to the record growth we're experiencing today, through investments in quality audience, technology, and a cohesive go-to-market strategy.

The progress we continue to make on our attribution initiatives will also support our dealer retention strategy. We now have several quarters of Roxanne data, which shows that consumers who are cross-shopping between

Cars.com and a dealer's own website are far more engaged and likely to buy a car from that dealer. These analytics and tools and solutions are unlike any offered by our competitors and put Cars.com in a unique position.

Gaining complete control over affiliate markets has been a key tenet of our strategy to better address the needs of dealer customers and unlock value of our solution strategy through dedicated experienced sellers. I'm proud to say that October marked the end of the affiliate network for Cars, and we have successfully converted the last affiliate dealers to our direct control. This is not only expected to drive $50 million in incremental free cash flow uplift beginning in 2020, but it also gives us complete control over our go-to-market capabilities in all markets for the first time in our history.

I spoke with one of our recently converted franchise dealers and he said to me and I quote, "When we were pitched by the newspaper, Cars.com and [indiscernible] (00:05:37) were being sold to us as part of bundle of print products, so honestly we didn't want or understand the value proposition. The affiliate rep couldn't explain to us how they could help our business. And after a few calls with our dedicated rep, we are now going to be customers of Dealer Inspire, Cars.com, and DealerRater, and I feel much better about my investment."

This feedback is very typical of what we hear when we convert a market to direct. Having direct control of all of our customer relationships going forward is a big step in our sales transformation and positions us for growth.

Another success we had in executing our strategy is around audience growth, which continues to accelerate, reaching our highest levels of unique visitors this past quarter. In a marketplace such as ours, audience is truly a key reflection of consumer preference and the data clearly illustrates that we're a leader in consumer acquisition.

Our growth continued in Q3 with unique visitors and traffic up 22% and 27% year-over-year, respectively. Combined with a superior Cars.com brand, organic and acquired audience strength have resulted in notable market share gains at the expense of competitors throughout the year.

Furthermore, our investments in product and technology continue to pay off, including a 30% year-over-year increase in SEO traffic. Steady and persistent focus on SEO has yielded market-leading results, which has produced the highest number of SEO visits and leads in 20 years. Achieving market leadership takes time, but I'm pleased that our diligent SEO strategy has now earned us the highest SEO performance in our category.

Translating these notable audience achievements and the market-leading dealer count is the ultimate objective. And to do this, we have to drive high-quality leads to our customers, which will improve their ROI from our platform, and our organic sources of traffic are very valuable to our customers, because they are getting quality traffic that they can only get from Cars.com.

We are also making strategic shifts in our marketing investments that are making us far more efficient. For example, our traffic generated through paid channels nearly doubled in the third quarter. However, our media spend only grew 4%. And we continue to generate the vast majority of our traffic from organic sources.

Now, let's talk about our national advertising business, which continues to face headwinds in the current environment. However, as we talk to OEMs, there is no shortage of demand to reach in-market undecided car shoppers, the very audience in which we are taking share. Combined with traffic share gains, we continue to innovate in solutions and formats that meet the evolving OEM needs.

To help drive this strategy forward, we welcomed a new team member in September, and I'm incredibly excited to welcome Julie Scott to Cars.com. Julie is an experienced digital marketing leader who will drive growth in our national advertising channel, focusing on business driving media solutions for OEMs.

One of the most exciting developments this quarter is our new opportunity to work directly with GM dealers nationwide. We also are excited about our new partnerships with Hyundai and Mitsubishi. Our OEM relationships continue to grow across our portfolio, which reinforces our digital solutions strategy and our differentiation as an online marketplace and solutions provider.

Our portfolio now includes a total of 28 OEM partnerships. For GM, we're one of only four certified providers and can now sell our leading edge digital website services to more than 4,100 GM dealers, who now have a choice of providers for the first time in 15 years. The GM program is currently in the dealer enrolment phase, with the first websites expected to launch in Q1 2020. We expect subscription-based website development revenue to be an important growth driver for us for years to come.

Ultimately we believe this is much more than just websites. These new relationships that we're building with OEMs, like GM, create a halo effect, cascading into longer-term conversations both with our traditional and emerging data-driven advertising and marketing solutions. To that end, as you may have seen, we announced this morning that Dean Evans, an accomplished auto industry innovator, has joined Cars as Executive Vice President. Dean is an important addition to our leadership team, as he sees the bigger solution strategy that we're driving to help sellers be more effective with technology.

We have substantial automotive industry know-how and digital technology that can be further leveraged for growth. Dean's expertise, leadership, and impressive track record for ramping auto sales is unprecedented. Our vision is to create a competitive advantage for our customers and further evolve the business from a traditional marketplace to a full-service marketing and technology solutions provider.

Before I turn the call over to Becky, let me just reinforce that our team is laser-focused on execution. With the strategic alternatives review process now fully behind us, I'm confident in our ability to devote our full attention to driving the return to growth expected in 2020.

I'd now like to turn the call over to Becky to go through our financial results for the third quarter of 2019.

Becky A. Sheehan
Chief Financial Officer, Cars.com, Inc.

Thank you, Alex. Revenue for the third quarter of 2019 was $152.1 million compared to $169.3 million in the prior year period. The decline was primarily driven by fewer dealer customers and lower national advertising revenue, offset in part by incremental revenue from the newly converted affiliate markets and growth in our Dealer Inspire solutions business.

Direct revenue was up $3.4 million year-over-year, driven by $14.2 million in revenue uplift from the affiliate market conversion and 25% growth from our Dealer Inspire solutions sales. Wholesale revenue of $5.4 million declined $12.3 million compared to the prior year, of which $9.6 million was the result of a conversion of the affiliate market. Excluding the affiliate market conversion, wholesale revenue was down $2.7 million, driven by a decline in affiliate dealer customers.

As a reminder, with the final conversion of the dealer market that took place on October 1, we no longer have a wholesale channel. In addition, the unfavorable contract liability is now fully amortized and the $6.3 million quarterly benefit from this amortization has ended.

Our national advertising business was down $7.9 million, or 28%, in the third quarter compared to the prior year period. As Alex mentioned, while traffic growth increases our advertising opportunity, we are also taking a number of steps to improve our current product offering and introduce new solutions.

Now let me move into a discussion of our operating expenses in the quarter. Although our goodwill impairment analysis is normally performed in the fourth quarter, we determine there was a triggering event in the third quarter, primarily caused by a sustained decrease in the company's stock price after the completion of the strategic alternatives review process. Therefore, we performed an interim quantitative impairment test during the third quarter.

As a result of that test, we recorded a noncash goodwill and intangible asset impairment charge of $461.5 million, because the book value of our assets exceeded the estimated fair value. We do not expect this noncash impairment charge to have any impact on our operations, liquidity, or cash flows, or affect compliance with our financial covenants under our credit agreement. The cash benefit from the deductible goodwill and intangible assets for tax purposes remains intact.

Excluding the impairment charge, total operating expenses for the third quarter of 2019 were $138.3 million compared to $141 million for the prior-year period. This reduction was primarily due to lower head count-related costs.

Net loss for the third quarter of 2019 was $426.2 million, or $6.38 per diluted share. Adjusted net income for the third quarter of 2019 was $21.3 million, or $0.32 per diluted share, compared to $38.4 million, or $0.55 per diluted share, in the third quarter of 2018. Adjusted EBITDA for the third quarter of 2019 was $45.9 million, or 30% of revenue, compared to $62.2 million for the prior-year period.

As Alex mentioned, we continue to set new records in our audience growth with unique visits growing 22% and traffic growing 27% year-over-year. ARPD was up 1% sequentially from last quarter, driven by our successful conversion of the affiliate markets. Last year, we did not include revenue from our website products in ARPD, and on that basis, ARPD declined 2%, primarily driven by dealer mix.

Dealer customers were 18,635 at September 30, 2019, down 256, or 1%, compared to June 30, 2019. This decline was primarily driven by a decline in direct marketplace dealer customers and dealers who canceled in the affiliate-converted market. Digital solutions only customers grew in the quarter.

Net cash provided by operating activities for the nine-month period ending September 30, 2019 was $80.6 million compared to $121.1 million in the prior year. Free cash flow for the nine-month period ending September 30, 2019 was $65.1 million compared to $111.1 million in the same period last year. Keep in mind that in the nine-month period, we incurred $23.6 million of costs associated with affiliate revenue share payments, which is $4.3 million higher than we incurred in the prior year period.

Cash and cash equivalents was $19.8 million and debt outstanding was $666.6 million as of September 30, 2019. During the nine-month period, we reduced our indebtedness by $29.7 million. Net leverage at September 30, 2019 was 3.4 times, calculated in accordance with our credit agreement.

In October, we announced an amendment to our existing credit agreement that resets our total net leverage covenant for the remaining term of the agreement. This amendment increased our maximum total leverage ratio to 4.5 times, with incremental step-downs in that ratio through maturity on May 31, 2022. This amendment provides increased financial flexibility in an ample capacity to respond to market changes.

We are reiterating the guidance we communicated last quarter of revenue declines between 6% and 9% year-over-year, with adjusted EBITDA margin between 27% and 29%.

At this time, I'd like to turn the call back to Alex for some closing remarks.

T. Alex Vetter
President, Chief Executive Officer & Director, Cars.com, Inc.

Thank you, Becky. While our building blocks for the future remain unchanged, we're focused on four key priorities as we close out this year. First, we will continue to take share in traffic and improve our overall value delivery. Second, with the affiliate channel now complete, we're fully focused on serving all of our customers directly. Third, we're focused on securing as many of the 4,100 GM dealers as we can, taking advantage of our semi-exclusive opportunity. And finally, we will continue to innovate new solutions that drive growth and customer success.

And with that, I'd like to open the call up to your questions. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question comes from the line of Tom White from D.A. Davidson. Your line is open.

Tom White
Analyst, D.A. Davidson Companies

Q

Thank you for taking my questions. Good morning, everyone. Just, Alex, on dealer count, it sounds like October has been a strong start to the quarter, I think you said nearly 100 net adds. Can we extrapolate that you guys are going to be able to grow dealers again – net dealers for the fourth quarter, now that given the affiliate conversions are behind you, the traffic trends are very strong?

And then just on the traffic growth, obviously, very impressive. Any sense you can give us of what downstream lead volume growth is looking like – or looked like in the quarter? And then just lastly that Dean Evans hiring announcement, there's some discussion in there around digital video. I was just hoping you could elaborate there a bit about how that kind of fits into your broader solutions strategy and product portfolio? Thanks.

T. Alex Vetter
President, Chief Executive Officer & Director, Cars.com, Inc.

A

Sure, Tom, thanks. Well, look, we certainly are reassured on the dealer growth in October, having the first full month where we've had no focus on affiliate conversions and have complete control of the dealer network. It's not lost to me that that's the first month we hit our full stride. And what I also, though, say is that, Q4 typically is a tough season in the auto industry as dealers try to make short-term decisions to meet bottom line. So we don't want to declare victory yet on dealer growth in Q4. But certainly to your second point, the traffic trends are moving in all the right ways.

And I think your point is how does that translate to dealer value. Our leads are up for the quarter. Obviously, growing traffic translates to advertiser satisfaction. So, we're pleased with what we're seeing in our dealer pulse surveys as well in terms of their overall satisfaction.

Your final question was about Dean and I'll just remind you that Dean's been a client. Dean has been on the other side of the desk buying media from everyone in the industry. And as we approached Dean about 2020 in using data as our superpower and helping them with their television advertising, I think his eyes lit up and saw a bigger opportunity to not only do this for OEMs, but for dealers. And I think that that solutions strategy is one of the key reasons that Dean is here.

Tom, you will recall that when we bought Dealer Inspire, one of the hidden gems inside that business was a programmatic advertising platform called Fuel, and that allows us to run advertisings solutions that scale in a programmatic fashion. And the biggest add that I've seen in technology in the past year has been the advent of digital video. And we think there's a massive opportunity to help dealers become more efficient and migrate traditional and linear TV budgets towards more effective and accountable digital channels. And so, Dean's here to help us realize that vision.

Becky A. Sheehan
Chief Financial Officer, Cars.com, Inc.
A

And, Tom, it's Becky. Just to add one more comment to what Alex said to your first question. I'll remind you that although dealer growth is certainly an important metric that we have for ourselves, it's not necessary for us to grow dealer count in Q4 to achieve the guidance that we've provided.

Tom White
Analyst, D.A. Davidson Companies
Q

Got it. Thank you very much.

Operator: Our next question comes from the line of Gary Prestopino from Barrington Research. Your line is open.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.
Q

Good morning, everyone.

T. Alex Vetter
President, Chief Executive Officer & Director, Cars.com, Inc.
A

Hey, Gary.

Becky A. Sheehan
Chief Financial Officer, Cars.com, Inc.
A

Hey, Gary.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.
Q

The ability to go after these websites from the dealerships, how do those contracts shake out? Are they all up for grabs in the current year, or is it a lot like the DMS that they renew every five years or something like that?

T. Alex Vetter
President, Chief Executive Officer & Director, Cars.com, Inc.

A

Thank you, Gary. First of all, I think you're speaking specifically to GM and that new opportunity, but also just point that both Hyundai and Mitsubishi were additions in the quarter and we've also got agreements now with Subaru and Lexus. And they all have some uniqueness. But dealers tend to be free to move from one website provider to another without much contractual overhead.

The GM opportunity is a little bit slower roll, because there's multiple sign-up phases for dealerships. GM's doing a roadshow for dealers, where they're educating them on the four partners that are available to them to choose from. And so, we're actively out meeting with all the GM dealers and showing them what we can do for them in the new year.

And so, the dealer count gains we've seen there initially are pleasing. We know we're in the number one position as the most requested vendor in the semi-exclusive bunch. But again, it's going to be slow rolling, and that revenue really won't hit until 2020, because we're just in a sign-up phase.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Q

Okay. And then can you wrap some metrics around this for us? With just selling pure technology solutions in the quarter, what kind of revenues was that generating on a recurring annual basis and what was the growth in that? Do you have those metrics handy?

T. Alex Vetter
President, Chief Executive Officer & Director, Cars.com, Inc.

A

Business solutions growth was over 20%, Gary. Becky will have to give you the closer numbers. But we continue to see increased pacing as we ramp that business. Becky, I don't know if you have a point estimate.

Becky A. Sheehan
Chief Financial Officer, Cars.com, Inc.

A

Yeah. So for the quarter, our Dealer Inspire solutions business was almost $20 million of revenue. That's up 25% year-over-year. And importantly, within there is our website business, which is up 40% on a year-over-year basis. So we continue to see very strong growth. The difference between the website growth and the total growth is simply that the performance marketing solutions that we also bring to our dealers to help them drive their local business, that has more ins and outs during any particular period of time. But we're certainly continuing to see the strong growth that we had earlier this year as well.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Q

Okay. And then lastly, somebody asked this on a prior question, did you give a number for how much leads were up this quarter? Are you making that public?

T. Alex Vetter
President, Chief Executive Officer & Director, Cars.com, Inc.

A

We didn't disclose it, but leads are up in the quarter and they're following a strong both Q2 as well. So Q2 and Q3 leads per dealer are up, as well our total leads.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc. Q

Okay. Thank you.

Becky A. Sheehan
Chief Financial Officer, Cars.com, Inc. A

Thanks, Gary.

Operator: Our next question comes from the line of Lee Krowl from B. Riley FBR. Your line is open.

Lee Krowl
Analyst, B. Riley FBR, Inc. Q

Hey, guys. Thanks for taking my question and good to see some of the trends are trending up. Last quarter you guys kind of provided some guidance for 2020. I noticed it wasn't kind of in the prepared remarks. Just curious if there's any changes to the commentary from the last call as to you expect to return to revenue growth in 2020 and double-digit EBITDA growth.

T. Alex Vetter
President, Chief Executive Officer & Director, Cars.com, Inc. A

I think, obviously, we're affirming our 2019, and then we're going to be on our regular cycle now and give guidance for 2020 at our typical time.

Lee Krowl
Analyst, B. Riley FBR, Inc. Q

Okay. And then just on the affiliate conversions, certainly exciting to see October off to a good trend. But is there maybe a way of – you've had enough conversions to this point to maybe handicap some anticipated churn or maybe quantify the anticipated churn of the affiliates. Obviously, it seems like there's some natural attrition. But is there a way to kind of think about how as you get all these guys fully onboarded, how that churn kind of churns out over the next couple of quarters.

T. Alex Vetter
President, Chief Executive Officer & Director, Cars.com, Inc. A

Sure. I think we do have a lot more experience. I think we pointed to ARPD in the quarter being a solid one. What's important for investors to also realize is that the final affiliate conversions were from media markets that tend to be on the lower end of our rate card. Our pricing models skews by both market size and dealer size, and most of the final affiliate conversions were to dealers in rural and smaller markets with smaller lots. But I think going forward what investors should be excited about is our growing solutions strategy that will emphasize ARPD and increase dealer spending as well.

So we know we will continue to have some churn. It's been pretty durable in our business and competitors as well. And so I think – but we've really cut the cancellation rate. That's probably been the biggest achievement this year is we brought cancellations down into a much more manageable volume, and we're really focused now on total gross sales. We haven't declared victory yet, although October certainly points to a new muscle that we're getting much better at. But we still have some more work to do there, candidly.

Lee Krowl
Analyst, B. Riley FBR, Inc.

Q

Got it. And then last question for me. Pretty exciting developments that you guys kind of highlighted with Roxanne. Can you maybe just talk to kind of the data privacy laws that are coming on and perhaps how Roxanne is future proof from that? And then also just kind of as this continued shift to mobile, perhaps how that plays into the strategy around Roxanne as well.

T. Alex Vetter
President, Chief Executive Officer & Director, Cars.com, Inc.

A

Sure. Well, from a data privacy standpoint, what's key about Roxanne is we're largely using non-PII level data to validate our performance. But we see very vividly in the data is that users that go to a dealer's website that originate on Cars.com are converting to dealer metrics at 4 times the rate of all of their other traffic sources combined. And so this is the data that dealers have needed to validate that. Migrating website traffic from Cars to their environment is perhaps their best money in.

Your second question, though, beyond the privacy concerns, I may have missed. So if you could just run it past me one more time.

Lee Krowl
Analyst, B. Riley FBR, Inc.

Q

Just the strategy with Roxanne in the context of the continued shift in your traffic to mobile.

T. Alex Vetter
President, Chief Executive Officer & Director, Cars.com, Inc.

A

Yeah. Actually, I think it provides the same visibility in all environments, and there isn't any degradation in our visibility with mobile.

Lee Krowl
Analyst, B. Riley FBR, Inc.

Q

Got it. Thanks for taking my question, guys.

T. Alex Vetter
President, Chief Executive Officer & Director, Cars.com, Inc.

A

Okay.

Becky A. Sheehan
Chief Financial Officer, Cars.com, Inc.

A

Thank you.

Operator: Our next question comes from the line of Daniel Powell from Goldman Sachs. Your line is open.

Daniel Powell
Analyst, Goldman Sachs & Co. LLC

Q

Great. Thank you. I appreciate the time. Two questions. One, I just wanted to get your view on kind of the cadence of ARPD as we go into the back part of this year and into next year. You called out mix as being a reason for some of the pressure on the year-over-year growth in the quarter. As you guys go out with your reorg sales force, are you expecting to continue to see negative impacts from mix? Are you sort of further down the tail of dealers that you can add at this at this point in time?

And then the second question, if I was reading the numbers correctly, it look like spend went from about up 15% last quarter to about up 4% this quarter. But you saw a nice acceleration in traffic based on some of your SEO strength. Just curious if the leads number, did it accelerate from the up 9% last quarter like your traffic did or did it decelerate from that up 9% last quarter like your spend did? Thanks.

T. Alex Vetter
President, Chief Executive Officer & Director, Cars.com, Inc.

A

Sure. Thank you. Well, first of all, on ARPD mix, we're not projecting growth in that between now and year-end. We'll give a better outlook on that for 2020 as we lay in our different solutions and we dedupe dealerships by product type. And so that will be the data that will give you our 2020 outlook, but we aren't projecting ARPD growth in Q4.

I think as to lead volume, we did see sequential quarter drop, which is I think more reflective of the new car traffic, where we saw a stronger drop in new car volume than used, which I think reflects the seasonal cycle that we experience every year. Q4 tends to drop down, and then comes back in a stronger quarter in the first quarter.

And our marketing spend you noted, right? We were able to drop the marketing spend considerably, but the scaling of our SEO strategy has probably been the most exciting trend in our value delivery, which I think dealers know that traffic is the most valuable kind of traffic that they can acquire, because they're not competing for it in search and they are actually tapping into a new source of incremental sales as opposed to an arbitrage player who's bidding up search.

Daniel Powell
Analyst, Goldman Sachs & Co. LLC

Q

Great. Thanks.

Operator: And our next question comes from the line of Marvin Fong from BTIG. Your line is open.

Marvin Fong
Analyst, BTIG LLC

Q

Great. Thank you for taking my questions. First one, I guess just revisiting something we talked about last quarter with dealers little skittish, because gross profits on the used car side were down and the upsell of some of your ancillary products was getting a little tough. Could you just kind of update us on what the macro environment looks like with respect to dealers and how they're thinking about their ad spend? Thanks.

T. Alex Vetter
President, Chief Executive Officer & Director, Cars.com, Inc.

A

Sure. Marvin, thanks. I think dealer profitability continues to be the headline theme in the industry. As I travel the country and meet with dealers, that is their primary focus, which I think by the way sets us up great to introduce new alternatives to traditional advertising. Our video opportunity, I think, can really help dealers find a more profitable way to grow sales in 2020.

That said, I think they also are recognizing that the year has turned out to be not as catastrophic as one would have thought probably two months ago. And that there is still a healthy used car market that's growing, and new car sales, while dipping, are also still at very healthy levels. So I think the mood has improved and dealers have started to focus more on what they can do differently heading into 2020.

Marvin Fong
Analyst, BTIG LLC
Q

Great. Thanks, Alex. And two quick follow-ups. Becky, perhaps you have this. What was the listings in the quarter? And then other question just on national advertising, I think you had said before you've tried to get more aggressive on the upfronts. Could you just kind of update us, like remind me when the timing of those upfronts are and how you're thinking about capitalizing on that opportunity this coming year? Thanks.

Becky A. Sheehan
Chief Financial Officer, Cars.com, Inc.
A

Yeah, sure. So on the listings front, we have 4.4 million listings on our marketplace, so a very strong number. And as it relates to national advertising, we are in the midst of the upfront discussions and proposals with the calendar year OEM, so that's happening literally as we speak. We'll have more insights as to how that's progressing as we get closer to the year end. And then, of course, there are the fiscal OEMs where that happens closer to year-end timeframe and into the first quarter.

Marvin Fong
Analyst, BTIG LLC
Q

Okay, great. Thank you. Thank you, Alex. Thank you, Becky.

Becky A. Sheehan
Chief Financial Officer, Cars.com, Inc.
A

Thank you.

T. Alex Vetter
President, Chief Executive Officer & Director, Cars.com, Inc.
A

Thanks.

Operator: Our next question comes from the line of Nick Jones from Citi. Your line is open.

Nicholas Jones
Analyst, Citigroup Global Markets, Inc.
Q

Hi. Thanks for taking the questions. First of all, can you kind of update on your capital allocation strategy, given the increase in the net leverage ratio? And then secondly, as traffic continued to grow nicely and leads are growing, have the conversations with dealers changed at all? Are they looking for more tools internally on Cars.com's platform in addition to some of the new products? I guess, is attribution becoming more important or less as your traffic starts to ramp back?

T. Alex Vetter
President, Chief Executive Officer & Director, Cars.com, Inc.

A

I'll start with the second question, and turn it for Becky on our capital strategy. I think the conversation has definitely turned with franchise dealers. I think independent dealers continue to hold the line and look for just cost efficiency at the independent level. But franchise dealers absolutely are looking for technology solutions that can eliminate vendor costs and/or automate solutions for their dealerships to run more efficiently heading into next year.

And I would also say just more broadly on our sales team front, I definitely feel like we've moved more to front foot in terms of our value delivery, our data around attribution, and the evidence that we have that we're a higher quality source of sales than other providers. And that has been a welcome shift in the conversation.

Becky A. Sheehan
Chief Financial Officer, Cars.com, Inc.

A

And then on capital allocation in the near-term, our focus is – and we think it's more prudent to pay down some of the debt. You'll see we did a bit of that in the third quarter. The credit environment has tightened and, as we've talked with investors, we also have been encouraged to prioritize some deleveraging, which is what we're doing. We do still have an active share repurchase program. I think that's a proven tool to have as a public company. But in the near-term, our focus is on taking down some of the debt.

Nicholas Jones
Analyst, Citigroup Global Markets, Inc.

Q

Great. Thank you for taking my questions.

Operator: And our next question comes from the line of Steve Dyer from Craig-Hallum. Your line is open.

Steve Dyer
Analyst, Craig-Hallum Capital Group LLC

Q

Thanks. Good morning. Most of mine have been answered. Just one more kind of on churn, down 1% in the quarter, much, much better than it's been and, Alex, you noted it kind of swung net positive in October. Can you give us sort of the cadence of how that trended throughout the quarter? In other words, did you see linear improvement throughout the quarter, and then positive in October, or no?

T. Alex Vetter
President, Chief Executive Officer & Director, Cars.com, Inc.

A

Yeah. I think we did see fairly consistent improvement, particularly going Q1 to Q2 to Q3. The trend on the cancellation rate has continued to stabilize and improve. And on the gross sales front, mostly I think we had one – I'm looking at the data right now – one month in the quarter that didn't sequentially improve. But overall, if you look at the trend, gross sales volume has been steadily improving and the cancellation rate has been much more dramatically improving.

Steve Dyer
Analyst, Craig-Hallum Capital Group LLC

Q

Got it. Okay. And then in the release you talked about affiliate conversions are expected to generate an incremental $50 million of free cash flow in 2020. Can you sort of deconstruct that, provide a little bit more detail on what makes that amount up? Thanks.

Becky A. Sheehan
Chief Financial Officer, Cars.com, Inc.

A

Yeah. That's two components. So the first component is the wholesale to retail revenue uplift that we realize with the conversions complete. So, we get the actual retail revenue that's being billed to the dealers instead of collecting that $0.60 on the dollar, which is wholesale revenues. So, that's the first component.

The second component is the end of the payments that we're making to the former affiliate partners to have achieved the early conversion. So, you'll recall that we've been incurring extra payments to those former affiliate partners as part of our agreement to convert the markets early. So in the first half of next year, we still have some of those payments, particularly to the most recently converted affiliates. But by the midpoint of next year, those payments will end. And, obviously, there'll be more significant uplifts once that happens.

Steve Dyer
Analyst, Craig-Hallum Capital Group LLC

Q

Thank you.

Operator: And our next question comes from the line of Doug Arthur from Huber Research. Your line is open.

Douglas Middleton Arthur
Analyst, Huber Research Partners LLC

Q

Yeah, thanks. Becky, I'm wondering if you can just sort of disaggregate direct revenues in the quarter. You said Dealer Inspire, I think, was up 25%. And you said, I believe that the incremental impact of the affiliate conversions was $14.2 million. So, that's over a year ago, I assume. Can you speak to what that incremental impact was sequentially from Q2 for starters?

Becky A. Sheehan
Chief Financial Officer, Cars.com, Inc.

A

So, apologies, I'll have to look. I don't have Q2 in front of me. But you were right, the $14.2 million is the – I'll call it the uplift in retail revenue, a large portion of which, of course, comes out of the wholesale line. That's the first part that's an increment for Q3 on a year-over-year basis.

The Dealer Inspire growth on a year-over-year basis is 25%. That equates to approximately $4 million. And so, the offset, of course, to get to the $3.4 million that we grew on that direct line, which would be excluding national advertising, is the lower revenue we achieved from the notion that the subscription business has less dealers today than it did a year ago.

So, those are the key components. I don't have in front of me – apologies – what those year-over-year changes were for Q2. Certainly, we can get that and provide that as well. National advertising in the quarter is down 28%, so that's a $7.9 million decline on a year-over-year basis. So I think those are the key elements of the revenue.

Douglas Middleton Arthur
Analyst, Huber Research Partners LLC

Q

So, excluding Dealer Inspire, obviously, very impressive growth and the affiliate conversions. The baseline figure I was using for direct excluding all that last year in the third quarter was $78 million. So that – I don't know if that's right or not, but that's the number I was using. So the underlying direct number, that I assumed was down sort of high double digits then in the quarters, is that fair, excluding the impact of the conversions?

Becky A. Sheehan
Chief Financial Officer, Cars.com, Inc.

A

Yes.

Douglas Middleton Arthur
Analyst, Huber Research Partners LLC

Q

Okay, terrific. Thank you very much.

Operator: We have no further questions in queue. I'll turn the call back to Alex Vetter for closing remarks.

T. Alex Vetter
President, Chief Executive Officer & Director, Cars.com, Inc.

I simply want to say thanks for joining today. We'll talk to you soon.

Operator: Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.