

CARMAX INC
Form 10-Q
October 10, 2012
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 August 31, 2012

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number: 1-31420

CARMAX, INC.

(Exact name of registrant as specified in its charter)

VIRGINIA 54-1821055
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

12800 TUCKAHOE CREEK PARKWAY, RICHMOND, VIRGINIA 23238

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(Address of principal executive offices)

(Zip Code)

(804) 747-0422

(Registrant's telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No o

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

Large accelerated filer x Accelerated filer o
Non-accelerated filer o Smaller reporting company o

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

Yes o No x

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

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Class	Outstanding as of September 30, 2012
Common Stock, par value \$0.50	228,812,854

A Table of Contents is included on Page 2 and a separate Exhibit Index is included on Page 40.

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CARMAX, INC. AND SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CARMAX, INC. AND SUBSIDIARIES

Consolidated Statements of Earnings

(Unaudited)

(In thousands except per share data)	Three Months Ended August 31				Six Months Ended August 31			
	2012	% ⁽²⁾	2011 ⁽¹⁾	% ⁽²⁾	2012	% ⁽²⁾	2011 ⁽¹⁾	% ⁽²⁾
SALES AND OPERATING REVENUES:								
Used vehicle sales	\$ 2,191,964	79.5	\$ 2,014,983	77.9	\$ 4,380,871	79.2	\$ 4,086,523	77.6
New vehicle sales	61,393	2.2	46,853	1.8	116,850	2.1	108,739	2.1
Wholesale vehicle sales	437,050	15.8	457,870	17.7	904,845	16.4	935,664	17.8
Other sales and revenues	67,597	2.5	68,113	2.6	129,858	2.3	136,310	2.6
NET SALES AND OPERATING REVENUES								
	2,758,004	100.0	2,587,819	100.0	5,532,424	100.0	5,267,236	100.0
Cost of sales	2,390,011	86.7	2,233,544	86.3	4,782,516	86.4	4,529,866	86.0
GROSS PROFIT	367,993	13.3	354,275	13.7	749,908	13.6	737,370	14.0
CARMAX AUTO FINANCE INCOME								
Selling, general and administrative expenses	254,674	9.2	229,887	8.9	508,277	9.2	471,542	9.0
Interest expense	8,152	0.3	8,464	0.3	16,295	0.3	17,004	0.3
Other income	259		110		544		213	
Earnings before income taxes	181,102	6.6	179,860	7.0	376,735	6.8	382,524	7.3
Income tax provision	69,466	2.5	68,706	2.7	144,353	2.6	145,870	2.8
NET EARNINGS	\$ 111,636	4.0	\$ 111,154	4.3	\$ 232,382	4.2	\$ 236,654	4.5

WEIGHTED AVERAGE COMMON
SHARES:

Basic	228,366	226,300	228,069	225,935
Diluted	231,696	230,681	231,749	230,479

NET EARNINGS PER SHARE:

Basic	\$ 0.49	\$ 0.49	\$ 1.02	\$ 1.05
Diluted	\$ 0.48	\$ 0.48	\$ 1.00	\$ 1.03

(1) As discussed in Note 2, fiscal 2012 reflects the revisions to correct our accounting for sale-leaseback transactions.

(2) Percents are calculated as a percentage of net sales and operating revenues and may not equal totals due to rounding.

See accompanying notes to consolidated financial statements.

CARMAX, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

(Unaudited)

(In thousands)	Three Months Ended		Six Months Ended	
	August 31 2012	2011 ⁽¹⁾	August 31 2012	2011 ⁽¹⁾
NET EARNINGS	\$ 111,636	\$ 111,154	\$ 232,382	\$ 236,654
Other comprehensive income (loss), net of taxes:				
Retirement plans:				
Amortization recognized in net pension expense ⁽²⁾	189	103	449	158
Cash flow hedges:				
Effective portion of changes in fair value ⁽³⁾	6,465	(6,487)	4,634	(10,612)
Reclassifications to CarMax Auto Finance income ⁽⁴⁾	730	975	3,965	2,095
Other comprehensive income (loss), net of taxes	7,384	(5,409)	9,048	(8,359)
TOTAL COMPREHENSIVE INCOME	\$ 119,020	\$ 105,745	\$ 241,430	\$ 228,295

⁽¹⁾ As discussed in Note 2, fiscal 2012 reflects the revisions to correct our accounting for sale-leaseback transactions.

⁽²⁾ Net of tax of \$111 and \$14 for the three months ended August 31, 2012 and 2011, respectively; and \$151 and \$72 for the six months ended August 31, 2012 and 2011, respectively.

⁽³⁾ Net of tax benefit of \$9,845 and \$4,218 for the three months ended August 31, 2012 and 2011, respectively; and \$11,026 and \$6,506 for the six months ended August 31, 2012 and 2011, respectively. The three months and six months ended August 31, 2012, include a tax benefit adjustment of \$8,518 related to prior years.

⁽⁴⁾ Net of tax of \$2,563 and \$0 for the three months ended August 31, 2012 and 2011, respectively; and \$2,563 and \$0 for the six months ended August 31, 2012 and 2011, respectively. The three months and six months ended August 31, 2012, include a tax provision adjustment of \$1,270 related to the first quarter of fiscal 2013.

See accompanying notes to consolidated financial statements.

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CARMAX, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

(In thousands except share data)	(Unaudited)	
	August 31, 2012	February 29, 2012
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 458,567	\$ 442,658
Restricted cash from collections on auto loan receivables	204,731	204,314
Accounts receivable, net	70,426	86,434
Inventory	1,198,013	1,092,592
Deferred income taxes	7,705	9,938
Other current assets	22,106	17,512
TOTAL CURRENT ASSETS	1,961,548	1,853,448
Auto loan receivables, net	5,315,232	4,959,847
Property and equipment, net	1,347,313	1,278,722
Deferred income taxes	143,754	133,134
Other assets	103,593	106,392
TOTAL ASSETS	\$ 8,871,440	\$ 8,331,543
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	\$ 221,430	\$ 324,827
Accrued expenses and other current liabilities	116,167	128,973
Accrued income taxes	557	3,125
Short-term debt	1,068	943
Current portion of finance and capital lease obligations	15,325	14,108
Current portion of non-recourse notes payable	171,292	174,337
TOTAL CURRENT LIABILITIES	525,839	646,313
Finance and capital lease obligations, excluding current portion	345,628	353,566
Non-recourse notes payable, excluding current portion	4,909,702	4,509,752
Other liabilities	140,684	148,800
TOTAL LIABILITIES	5,921,853	5,658,431
Commitments and contingent liabilities		
SHAREHOLDERS' EQUITY:		
Common stock, \$0.50 par value; 350,000,000 shares authorized;		
228,444,532 and 227,118,666 shares issued and outstanding		

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as of August 31, 2012 and February 29, 2012, respectively	114,222	113,559
Capital in excess of par value	911,875	877,493
Accumulated other comprehensive loss	(53,411)	(62,459)
Retained earnings	1,976,901	1,744,519
TOTAL SHAREHOLDERS' EQUITY	2,949,587	2,673,112
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 8,871,440	\$ 8,331,543

See accompanying notes to consolidated financial statements.

CARMAX, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(Unaudited)

(In thousands)	Six Months Ended August 31	
	2012	2011 ⁽¹⁾
OPERATING ACTIVITIES:		
Net earnings	\$ 232,382	\$ 236,654
Adjustments to reconcile net earnings to net cash used in operating activities:		
Depreciation and amortization	46,442	39,454
Share-based compensation expense	30,206	26,303
Provision for loan losses	22,090	9,783
Loss on disposition of assets	446	1,195
Deferred income tax (benefit) provision	(76)	3,608
Net decrease (increase) in:		
Accounts receivable, net	16,008	54,748
Inventory	(105,421)	(11,832)
Other current assets	(4,605)	11,648
Auto loan receivables, net	(377,475)	(388,282)
Other assets	971	(1,969)
Net decrease in:		
Accounts payable, accrued expenses and other current liabilities and accrued income taxes	(132,469)	(42,095)
Other liabilities	(14,431)	(15,139)
NET CASH USED IN OPERATING ACTIVITIES	(285,932)	(75,924)
INVESTING ACTIVITIES:		
Capital expenditures	(103,918)	(80,225)
(Increase) decrease in restricted cash from collections on auto loan receivables	(417)	6,108
Increase in restricted cash in reserve accounts	(3,151)	(4,562)
Release of restricted cash from reserve accounts	7,992	6,997
Purchases of money market securities, net	(2,104)	(291)
Purchases of investments available-for-sale	(1,227)	(2,164)
Sales of investments available-for-sale	318	
NET CASH USED IN INVESTING ACTIVITIES	(102,507)	(74,137)
FINANCING ACTIVITIES:		
Increase in short-term debt, net	125	331
Payments on finance and capital lease obligations	(6,721)	(6,093)
Issuances of non-recourse notes payable	2,345,000	1,869,000
Payments on non-recourse notes payable	(1,948,095)	(1,584,059)

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Equity issuances, net	4,209	4,362
Excess tax benefits from share-based payment arrangements	9,830	7,312
NET CASH PROVIDED BY FINANCING ACTIVITIES	404,348	290,853
Increase in cash and cash equivalents	15,909	140,792
Cash and cash equivalents at beginning of year	442,658	41,121
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 458,567	\$ 181,913

(1) As discussed in Note 2, fiscal 2012 reflects the revisions to correct our accounting for sale-leaseback transactions.

See accompanying notes to consolidated financial statements.

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CARMAX, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(Unaudited)

1. Background

CarMax, Inc. (“we,” “our,” “us,” “CarMax” and “the company”), including its wholly owned subsidiaries, is the largest retailer of used vehicles in the United States. We were the first used vehicle retailer to offer a large selection of high quality used vehicles at competitively low, no-haggle prices using a customer-friendly sales process in an attractive, modern sales facility. We provide customers with a full range of related products and services, including the appraisal and purchase of vehicles directly from consumers; the financing of vehicle purchases through our own finance operation, CarMax Auto Finance (“CAF”), and third-party financing providers; the sale of extended service plans (“ESP”), guaranteed asset protection (“GAP”) and accessories; and vehicle repair service. Vehicles purchased through the appraisal process that do not meet our retail standards are sold to licensed dealers through on-site wholesale auctions. At select locations we also sell new vehicles under various franchise agreements.

2. Accounting Policies

Basis of Presentation and Use of Estimates. The accompanying interim unaudited consolidated financial statements include the accounts of CarMax and our wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. These consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles (“GAAP”) for interim financial information. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, such interim consolidated financial statements reflect all normal recurring adjustments considered necessary to present fairly the financial position and the results of operations and cash flows for the interim periods presented. The results of operations for the interim periods are not necessarily indicative of the results to be expected for the full fiscal year. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and footnotes included in our Annual Report on Form 10-K for the fiscal year ended February 29, 2012.

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities. Actual results could differ from those estimates. Certain prior year amounts have been reclassified to conform to the current year’s presentation. Amounts and percentages may not total due to rounding.

Cash and Cash Equivalents. Cash equivalents of \$50.1 million as of August 31, 2012, and \$429.3 million as of February 29, 2012, consisted of highly liquid investments with original maturities of three months or less.

Restricted Cash from Collections on Auto Loan Receivables. Cash accounts totaling \$204.7 million as of August 31, 2012, and \$204.3 million as of February 29, 2012, consisted of collections of principal and interest payments on securitized auto loan receivables that are restricted for payment to the securitization investors pursuant to the applicable securitization agreements.

Securitizations. We maintain a revolving securitization program composed of two warehouse facilities (“warehouse facilities”) that we use to fund auto loan receivables originated by CAF until they are funded through a term securitization or alternative funding arrangement. We sell the auto loan receivables to a wholly owned, bankruptcy-remote, special purpose entity that transfers an undivided percentage ownership interest in the receivables, but not the receivables themselves, to entities formed by third-party investors (“bank conduits”). The bank conduits generally issue asset-backed commercial paper or utilize other funding sources supported by the transferred receivables, and the proceeds are used to finance the securitized receivables.

We typically use term securitizations to provide long-term funding for the auto loan receivables initially securitized through the warehouse facilities. In these transactions, a pool of auto loan receivables is sold to a bankruptcy-remote, special purpose entity that, in turn, transfers the receivables to a special purpose securitization trust. The securitization trust issues asset-backed securities, secured or otherwise supported by the transferred receivables, and the proceeds from the sale of the asset-backed securities are used to finance the securitized receivables.

We are required to evaluate term securitization trusts for consolidation. In our capacity as servicer, we have the power to direct the activities of the trusts that most significantly impact the economic performance of the receivables. In addition,

we have the obligation to absorb losses (subject to limitations) and the rights to receive any returns of the trusts, which could be significant. Accordingly, we are the primary beneficiary of the trusts and are required to consolidate them.

We recognize transfers of auto loan receivables into the warehouse facilities and term securitizations (“securitization vehicles”) as secured borrowings, which result in recording the auto loan receivables and the related non-recourse notes payable to the investors on our consolidated balance sheets.

The securitized receivables can only be used as collateral to settle obligations of the securitization vehicles. The securitization vehicles and investors have no recourse to our assets beyond the securitized receivables, the amounts on deposit in reserve accounts and the restricted cash from collections on auto loan receivables. We have not provided financial or other support to the securitization vehicles or investors that was not previously contractually required, and there are no additional arrangements, guarantees or other commitments that could require us to provide financial support to the securitization vehicles.

See Notes 4 and 9 for additional information on auto loan receivables and non-recourse notes payable.

Auto Loan Receivables, Net. Auto loan receivables include amounts due from customers primarily related to used retail vehicle sales financed through CAF and are presented net of an allowance for estimated loan losses. The allowance for loan losses represents an estimate of the amount of net losses inherent in our portfolio of managed receivables as of the applicable reporting date and anticipated to occur during the following 12 months. The allowance is primarily based on the credit quality of the underlying receivables, historical loss trends and forecasted forward loss curves. We also take into account recent trends in delinquencies and losses, recovery rates and the economic environment. The provision for loan losses is the periodic expense of maintaining an adequate allowance.

An account is considered delinquent when the related customer fails to make a substantial portion of a scheduled payment on or before the due date. In general, accounts are charged-off on the last business day of the month during which the earliest of the following occurs: the receivable is 120 days or more delinquent as of the last business day of the month, the related vehicle is repossessed and liquidated or the receivable is otherwise deemed uncollectible. For purposes of determining impairment, auto loans are evaluated collectively, as they represent a large group of smaller-balance homogeneous loans, and therefore, are not individually evaluated for impairment. See Note 4 for additional information on auto loan receivables.

Interest income and expenses related to auto loans are included in CAF income. Interest income on auto loan receivables is recognized when earned based on contractual loan terms. All loans continue to accrue interest until repayment or charge-off. Direct costs associated with loan originations are not considered material. See Note 3 for additional information on CAF income.

Other Assets. Other assets includes amounts classified as restricted cash on deposit in reserve accounts and restricted investments. The restricted cash on deposit in reserve accounts is for the benefit of holders of non-recourse notes payable, and these funds are not expected to be available to the company or its creditors. In the event that the cash generated by the securitized receivables in a given period was insufficient to pay the interest, principal and other required payments, the balances on deposit in the reserve accounts would be used to pay those amounts. Restricted cash on deposit in reserve accounts was \$40.5 million as of August 31, 2012, and \$45.3 million as of February 29, 2012.

Restricted investments includes money market securities primarily held to satisfy certain insurance program requirements, as well as mutual funds held in a rabbi trust established to fund informally our executive deferred compensation plan. Restricted investments was \$34.4 million as of August 31, 2012, and \$31.4 million as of February 29, 2012.

Finance Lease Obligations. As reported in our Annual Report on Form 10-K for fiscal 2012, we revised our consolidated financial statements to correct our accounting for sale-leaseback transactions. The revisions resulted from the misapplication of the sale-leaseback provisions of Financial Accounting Standards Board Accounting Standards Codification (“FASB ASC”) Topic 840, Leases, related to transactions we entered into between fiscal 1995 and 2009. We determined that our financial statements were not materially affected by the correction. The following tables summarize the impact of the revisions on the major financial statement line items for the three months and six months ended August 31, 2011.

Consolidated Statements of Earnings

(In thousands except per share data)	Three Months Ended August 31, 2011		
	Previously Reported	Adjustments	Revised
Selling, general and administrative expenses	\$ 236,435	\$ (6,548)	\$ 229,887
Interest expense	\$ 787	\$ 7,677	\$ 8,464
Earnings before income taxes	\$ 180,989	\$ (1,129)	\$ 179,860
Income tax provision	\$ 69,094	\$ (388)	\$ 68,706
Net earnings	\$ 111,895	\$ (741)	\$ 111,154
Net Earnings Per Share:			
Basic	\$ 0.49	\$	\$ 0.49
Diluted	\$ 0.49	\$ (0.01)	\$ 0.48

(In thousands except per share data)	Six Months Ended August 31, 2011		
	Previously Reported	Adjustments	Revised
Selling, general and administrative expenses	\$ 484,640	\$ (13,098)	\$ 471,542
Interest expense	\$ 1,578	\$ 15,426	\$ 17,004
Earnings before income taxes	\$ 384,852	\$ (2,328)	\$ 382,524
Income tax provision	\$ 146,669	\$ (799)	\$ 145,870
Net earnings	\$ 238,183	\$ (1,529)	\$ 236,654
Net Earnings Per Share:			
Basic	\$ 1.05	\$	\$ 1.05
Diluted	\$ 1.03	\$	\$ 1.03

Consolidated Statement of Cash Flows

(In thousands)	Six Months Ended August 31, 2011		
	Previously Reported	Adjustments	Revised
Net cash used in operating activities	\$ (81,641)	\$ 5,717	\$ (75,924)
Net cash provided by financing activities	\$ 296,570	\$ (5,717)	\$ 290,853
Increase in cash and cash equivalents	\$ 140,792	\$	\$ 140,792

Derivative Instruments and Hedging Activities. We enter into derivative instruments to manage exposures that arise from business activities that result in the future known receipt or payment of uncertain cash amounts, the values of which are impacted by interest rates. We recognize the derivatives at fair value as either current assets or current liabilities on the consolidated balance sheets. Where applicable, such contracts covered by master netting agreements

are reported net. Gross positive fair values are netted with gross negative fair values by counterparty. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether we have elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. We may enter into derivative contracts that are intended to economically hedge certain risks, even though hedge accounting may not apply or we do not elect to apply hedge accounting. See Note 5 for additional information on derivative instruments and hedging activities.

Recent Accounting Pronouncements. In December 2011, the Financial Accounting Standards Board (“FASB”) issued an accounting pronouncement related to offsetting of assets and liabilities on the balance sheet (FASB ASC Topic 210). The amendments require additional disclosures related to offsetting either in accordance with U.S. GAAP or master netting arrangements. The provisions for this pronouncement are effective for fiscal years, and interim periods within those years, beginning after January 1, 2013. We will adopt this pronouncement for our fiscal year beginning March 1, 2013. We do not expect this pronouncement to have a material effect on our consolidated financial statements.

In July 2012, the FASB issued an accounting pronouncement related to intangibles – goodwill and other (FASB ASC Topic 350), which permits companies to first consider qualitative factors as a basis for assessing impairment and

determining the necessity of a detailed impairment test of indefinite-lived intangible assets. The provisions for this pronouncement are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. We will adopt this pronouncement for our fiscal year beginning March 1, 2013. We do not expect this pronouncement to have a material effect on our consolidated financial statements.

3. CarMax Auto Finance Income

(In millions)	Three Months Ended August 31				Six Months Ended August 31			
	2012	% ⁽¹⁾	2011	% ⁽¹⁾	2012	% ⁽¹⁾	2011	% ⁽¹⁾
Interest margin:								
Interest and fee income	\$ 123.5	9.4	\$ 111.8	9.7	\$ 243.8	9.4	\$ 219.7	9.8
Interest expense	(23.9)	(1.8)	(26.2)	(2.3)	(49.0)	(1.9)	(54.7)	(2.4)
Total interest margin	99.6	7.6	85.6	7.5	194.8	7.5	165.0	7.3
Provision for loan losses	(12.9)	(1.0)	(10.8)	(0.9)	(22.1)	(0.9)	(9.8)	(0.4)
Total interest margin after provision for loan losses	86.7	6.6	74.8	6.5	172.7	6.7	155.2	6.9
Other (loss) income	(0.2)		0.4		(0.2)		1.1	
Direct expenses:								
Payroll and fringe benefit expense	(5.4)	(0.4)	(5.1)	(0.4)	(10.7)	(0.4)	(10.4)	(0.5)
Other direct expenses	(5.4)	(0.4)	(6.3)	(0.5)	(10.9)	(0.4)	(12.4)	(0.6)
Total direct expenses	(10.8)	(0.8)	(11.4)	(1.0)	(21.6)	(0.8)	(22.8)	(1.0)
CarMax Auto Finance income	\$ 75.7	5.8	\$ 63.8	5.6	\$ 150.9	5.8	\$ 133.5	5.9
Total average managed receivables	\$ 5,245.4		\$ 4,596.6		\$ 5,160.3		\$ 4,492.2	

⁽¹⁾ Annualized percent of total average managed receivables.

CAF provides financing for qualified customers at competitive market rates of interest. We securitize substantially all of the loans originated by CAF, as discussed in Note 2. CAF income primarily reflects the interest and fee income generated by the auto loan receivables less the interest expense associated with the debt issued to fund these receivables, a provision for estimated loan losses and direct CAF expenses.

CAF income does not include any allocation of indirect costs or income. We present this information on a direct basis to avoid making arbitrary decisions regarding the indirect benefits or costs that could be attributed to CAF. Examples of indirect costs not included are retail store expenses and corporate expenses such as human resources, administrative

services, marketing, information systems, accounting, legal, treasury and executive payroll.

4. Auto Loan Receivables

Auto loan receivables include amounts due from customers primarily related to used retail vehicle sales financed through CAF and are presented net of an allowance for estimated loan losses. We use warehouse facilities to fund auto loan receivables originated by CAF until they are funded through a term securitization or alternative funding arrangement. The majority of these amounts serve as collateral for the related non-recourse notes payable of \$5.08 billion as of August 31, 2012, and \$4.68 billion as of February 29, 2012. See Notes 2 and 9 for additional information on securitizations and non-recourse notes payable.

Auto Loan Receivables, Net

(In millions)	As of August 31		As of February 29 or 28	
	2012	2011	2012	2011
Warehouse facilities	\$ 1,066.0	\$ 1,559.0	\$ 553.0	\$ 943.0
Term securitizations	4,029.7	2,865.0	4,211.8	3,193.1
Other receivables ⁽¹⁾	246.4	283.7	217.0	198.5
Total ending managed receivables	5,342.1	4,707.7	4,981.8	4,334.6
Accrued interest and fees	25.7	24.7	23.1	20.9
Other	(3.1)	2.9	(1.8)	4.0
Less allowance for loan losses	(49.5)	(36.2)	(43.3)	(38.9)
Auto loan receivables, net	\$ 5,315.2	\$ 4,699.1	\$ 4,959.8	\$ 4,320.6

⁽¹⁾ Other receivables includes receivables not funded through the warehouse facilities or term securitizations.

Credit Quality. When customers apply for financing, CAF uses proprietary scoring models that rely on the customers' credit history and certain application information to evaluate and rank their risk. Credit histories are obtained from credit bureau reporting agencies and include information such as number, age, type of and payment history for prior or existing credit accounts. The application information that is used includes income, collateral value and down payment. Our scoring models yield credit grades that represent the relative likelihood of repayment. Customers assigned a grade of "A" are determined to have the highest probability of repayment, and customers assigned a lower grade are determined to have a lower probability of repayment. For loans that are approved, the credit grade influences the terms of the agreement, such as the required loan-to-value ratio and interest rate.

CAF uses a combination of the initial credit grades and historical performance to monitor the credit quality of the auto loan receivables on an ongoing basis. We validate the accuracy of the scoring models periodically. Loan performance is reviewed on a recurring basis to identify whether the assigned grades adequately reflect the customers' likelihood of repayment.

Ending Managed Receivables by Major Credit Grade

(In millions)	As of August 31				As of February 29 or 28			
	2012 ⁽¹⁾	% ⁽²⁾	2011 ⁽¹⁾	% ⁽²⁾	2012 ⁽¹⁾	% ⁽²⁾	2011 ⁽¹⁾	% ⁽²⁾
A	\$ 2,548.5	47.7	\$ 2,385.9	50.7	\$ 2,452.8	49.2	\$ 2,234.1	51.5
B	2,088.9	39.1	1,838.3	39.0	1,923.6	38.6	1,668.0	38.5
C and other	704.7	13.2	483.5	10.3	605.4	12.2	432.5	10.0
Total ending managed receivables	\$ 5,342.1	100.0	\$ 4,707.7	100.0	\$ 4,981.8	100.0	\$ 4,334.6	100.0

(1) Classified based on credit grade assigned when customers were initially approved for financing.

(2) Percent of total ending managed receivables.

Allowance for Loan Losses

(In millions)	Three Months Ended August 31				Six Months Ended August 31			
	2012	% ⁽¹⁾	2011	% ⁽¹⁾	2012	% ⁽¹⁾	2011	% ⁽¹⁾
Balance as of beginning of period	\$ 46.6	0.9	\$ 34.3	0.8	\$ 43.3	0.9	\$ 38.9	0.9
Charge-offs	(24.3)		(23.2)		(44.9)		(42.5)	
Recoveries	14.3		14.3		29.0		30.0	
Provision for loan losses	12.9		10.8		22.1		9.8	
Balance as of end of period	\$ 49.5	0.9	\$ 36.2	0.8	\$ 49.5	0.9	\$ 36.2	0.8

(1) Percent of total ending managed receivables as of the corresponding reporting date.

The allowance for loan losses represents an estimate of the amount of net losses inherent in our portfolio of managed receivables as of the applicable reporting date and anticipated to occur during the following 12 months. The allowance is primarily based on the credit quality of the underlying receivables, historical loss trends and forecasted forward loss curves. We also take into account recent trends in delinquencies and losses, recovery rates and the economic environment. The provision for loan losses is the periodic expense of maintaining an adequate allowance.

Past Due Receivables

(In millions)	As of August 31				As of February 29 or 28			
	2012	% ⁽¹⁾	2011	% ⁽¹⁾	2012	% ⁽¹⁾	2011	% ⁽¹⁾
Total ending managed receivables	\$ 5,342.1	100.0	\$ 4,707.7	100.0	\$ 4,981.8	100.0	\$ 4,334.6	100.0
Delinquent loans:								
31-60 days past due	\$ 103.9	1.9	\$ 95.4	2.0	\$ 85.1	1.7	\$ 86.6	2.0
61-90 days past due	31.3	0.6	27.5	0.6	21.8	0.4	24.2	0.6
Greater than 90 days past due	10.5	0.2	10.7	0.2	9.6	0.2	10.5	0.2
Total past due	\$ 145.7	2.7	\$ 133.6	2.8	\$ 116.5	2.3	\$ 121.3	2.8

⁽¹⁾ Percent of total ending managed receivables.

5. Derivative Instruments and Hedging Activities

Risk Management Objective of Using Derivatives. We are exposed to certain risks arising from both our business operations and economic conditions, particularly with regard to future issuances of fixed-rate debt and existing and future issuances of floating-rate debt. Primary exposures include LIBOR and other rates used as benchmarks in our securitizations. We enter into derivative instruments to manage exposures that arise from business activities that result in the future known receipt or payment of uncertain cash amounts, the values of which are impacted by interest rates. Our derivative instruments are used to manage differences in the amount of our known or expected cash receipts and our known or expected cash payments principally related to the funding of our auto loan receivables.

We do not anticipate significant market risk from derivatives as they are predominantly used to match funding costs to the use of the funding. However, disruptions in the credit or interest rate markets could impact the effectiveness of our hedging strategies.

Credit risk is the exposure to nonperformance of another party to an agreement. We mitigate credit risk by dealing with highly rated bank counterparties.

Cash Flow Hedges of Interest Rate Risk. Our objectives in using interest rate derivatives are to add stability to interest expense, to manage our exposure to interest rate movements and to better match funding costs to the interest received on the fixed-rate receivables being securitized. To accomplish these objectives, we primarily use interest rate swaps. Interest rate swaps designated as cash flow hedges involve the receipt of variable amounts from a counterparty in exchange for our making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount. These interest rate swaps are designated as cash flow hedges of forecasted interest payments in anticipation of permanent funding in the term securitization market.

For derivatives that are designated and qualify as cash flow hedges, the effective portion of changes in the fair value is initially recorded in accumulated other comprehensive loss (“AOCL”) and is subsequently reclassified into CAF income in the period that the hedged forecasted transaction affects earnings. The ineffective portion of the change in fair value of the derivatives is recognized directly in CAF income. Amounts reported in AOCL related to derivatives will be reclassified to CAF income as interest expense is incurred on our future issuances of fixed-rate debt. During the next 12 months, we estimate that an additional \$12.7 million will be reclassified as a decrease to CAF income.

As of August 31, 2012, we had interest rate swaps outstanding with a combined notional amount of \$993.0 million that were designated as cash flow hedges of interest rate risk.

Non-designated Hedges. Derivative instruments not designated as accounting hedges, including interest rate swaps and interest rate caps, are not speculative. These instruments are used to limit risk for investors in the warehouse facilities, to

minimize the funding costs related to certain term securitization vehicles and to mitigate interest rate risk associated with related financial instruments. Changes in the fair value of derivatives not designated as accounting hedges are recorded directly in CAF income.

As of August 31, 2012, we had interest rate swaps outstanding with a combined notional amount of \$11.1 million and interest rate caps outstanding with offsetting (asset and liability) notional amounts of \$790.4 million, which are not designated as accounting hedges.

Fair Values of Derivative Instruments on the Consolidated Balance Sheets. The table below presents the fair value of our derivative instruments as well as their classification on the consolidated balance sheets. See Note 6 for additional information on fair value measurements.

Fair Values of Derivative Instruments

(In thousands)	As of August 31, 2012		As of February 29, 2012	
	Assets	Liabilities	Assets	Liabilities
Derivatives designated as accounting hedges:				
Interest rate swaps ⁽¹⁾	\$	\$	\$ 11	\$
Interest rate swaps ⁽²⁾		(4,600)		(1,643)
Total derivatives designated as accounting hedges		(4,600)	11	(1,643)
Derivatives not designated as accounting hedges:				
Interest rate swaps ⁽¹⁾	8		304	
Interest rate swaps ⁽²⁾		(8)		(335)
Interest rate caps ⁽¹⁾	54	(54)	83	(81)
Total derivatives not designated as accounting hedges	62	(62)	387	(416)
Total	\$ 62	\$ (4,662)	\$ 398	\$ (2,059)

(1) Reported in other current assets on the consolidated balance sheets.

(2) Reported in accounts payable on the consolidated balance sheets.

Effect of Derivative Instruments on the Consolidated Statements of Earnings. The table below presents the effect of the company's derivative instruments on the consolidated statements of earnings.

Effect on the Consolidated Statements of Earnings

(In thousands)	Three Months Ended August 31		Six Months Ended August 31	
	2012	2011	2012	2011
Derivatives designated as accounting hedges:				
Loss recognized in AOCL ⁽¹⁾	\$ (3,380)	\$ (10,705)	\$ (6,392)	\$ (17,118)
Loss reclassified from AOCL into CAF income ⁽¹⁾	\$ (3,293)	\$ (975)	\$ (6,528)	\$ (2,095)
Derivatives not designated as accounting hedges:				
Loss recognized in CAF income ⁽²⁾	\$	\$ (35)	\$ (1)	\$ (75)

⁽¹⁾ Represents the effective portion.

⁽²⁾ Represents the loss on interest rate swaps, the net periodic settlements and accrued interest.

6. Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the principal market or, if none exists, the most advantageous market, for the specific asset or liability at the measurement date (referred to as the "exit price"). The fair value should be based on assumptions that market participants would use, including a consideration of nonperformance risk.

We assess the inputs used to measure fair value using the three-tier hierarchy. The hierarchy indicates the extent to which inputs used in measuring fair value are observable in the market.

Level 1 Inputs include unadjusted quoted prices in active markets for identical assets or liabilities that we can access at the measurement date.

Level 2 Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, including quoted prices for similar assets in active markets, quoted prices from identical or similar assets in inactive markets and observable inputs such as interest rates and yield curves.

Level 3 Inputs that are significant to the measurement that are not observable in the market and include management's judgments about the assumptions market participants would use in pricing the asset or liability (including assumptions about risk).

Our fair value processes include controls that are designed to ensure that fair values are appropriate. Such controls include model validation, review of key model inputs, analysis of period-over-period fluctuations and reviews by senior management.

Valuation Methodologies

Money market securities. Money market securities are cash equivalents, which are included in either cash and cash equivalents or other assets, and consist of highly liquid investments with original maturities of three months or less. We use quoted market prices for identical assets to measure fair value. Therefore, all money market securities are classified as Level 1.

Mutual fund investments. Mutual fund investments consist of publicly traded mutual funds that primarily include diversified investments in large-, mid- and small-cap domestic and international companies. The investments, which are included in other assets, are held in a rabbi trust and are restricted to funding informally our executive deferred compensation plan. We use quoted active market prices for identical assets to measure fair value. Therefore, all mutual fund investments are classified as Level 1.

Derivative instruments. The fair values of our derivative instruments are included in either other current assets or accounts payable. As described in Note 5, as part of our risk management strategy, we utilize derivative instruments

to manage differences in the amount of our known or expected cash receipts and our known or expected cash payments principally related to the funding of our auto loan receivables. Our derivatives are not exchange-traded and are over-the-counter customized derivative instruments. All of our derivative exposures are with highly rated bank counterparties.

We measure derivative fair values assuming that the unit of account is an individual derivative instrument and that derivatives are sold or transferred on a stand-alone basis. We estimate the fair value of our derivatives using quotes determined by the derivative counterparties and third-party valuation services. We validate certain quotes using our own internal models. Quotes from third-party valuation services, quotes received from bank counterparties and our internal models project future cash flows and discount the future amounts to a present value using market-based expectations for interest rates and the contractual terms of the derivative instruments. Because model inputs can typically be observed in the liquid market and the models do not require significant judgment, these derivatives are classified as Level 2.

Our derivative fair value measurements consider assumptions about counterparty and our own nonperformance risk. We monitor counterparty and our own nonperformance risk and, in the event that we determine that a party is unlikely to perform under terms of the contract, we would adjust the derivative fair value to reflect the nonperformance risk.

Items Measured at Fair Value on a Recurring Basis

(In thousands)	As of August 31, 2012				
	Level 1		Level 2	Total	
Assets:					
Money market securities	\$ 80,965		\$	\$ 80,965	
Mutual fund investments	3,495			3,495	
Derivative instruments			8	8	
Total assets at fair value	\$ 84,460		\$ 8	\$ 84,468	
Percent of total assets at fair value	100.0	%		%	100.0 %
Percent of total assets	1.0	%		%	1.0 %
Liabilities:					
Derivative instruments	\$		\$ 4,608	\$ 4,608	
Total liabilities at fair value	\$		\$ 4,608	\$ 4,608	
Percent of total liabilities		%	0.1	%	0.1 %

(In thousands)	As of February 29, 2012				
	Level 1		Level 2	Total	
Assets:					
Money market securities	\$ 458,090		\$	\$ 458,090	
Mutual fund investments	2,586			2,586	
Derivative instruments			317	317	
Total assets at fair value	\$ 460,676		\$ 317	\$ 460,993	
Percent of total assets at fair value	99.9	%	0.1	%	100.0 %
Percent of total assets	5.5	%		%	5.5 %
Liabilities:					
Derivative instruments	\$		\$ 1,978	\$ 1,978	
Total liabilities at fair value	\$		\$ 1,978	\$ 1,978	
Percent of total liabilities		%		%	%

7. Income Taxes

We had \$20.7 million of gross unrecognized tax benefits as of August 31, 2012, and \$20.9 million as of February 29, 2012. During the six months ended August 31, 2012, we settled federal and state liabilities of \$2.8 million related to the Internal Revenue Service audit of fiscal years 2008 through 2010. There were no other

significant changes to the gross unrecognized tax benefits as reported for the year ended February 29, 2012, as all activity was related to positions taken on tax returns filed or intended to be filed in the current fiscal year.

8. Retirement Plans

Effective December 31, 2008, we froze both of our noncontributory defined benefit plans: our pension plan (the “pension plan”) and our unfunded, nonqualified plan (the “restoration plan”), which restores retirement benefits for certain associates who are affected by Internal Revenue Code limitations on benefits provided under the pension plan. No additional benefits have accrued under these plans since that date. In connection with benefits earned prior to December 31, 2008, we have a continuing obligation to fund the pension plan and will continue to recognize net periodic

pension expense for both plans. We use a fiscal year end measurement date for both the pension plan and the restoration plan.

Components of Net Pension Expense

(In thousands)	Three Months Ended August 31					
	Pension Plan		Restoration Plan		Total	
	2012	2011	2012	2011	2012	2011
Interest cost	\$ 1,824	\$ 1,708	\$ 115	\$ 131	\$ 1,939	\$ 1,839
Expected return on plan assets	(1,913)	(1,717)			(1,913)	(1,717)
Recognized actuarial loss	300	117			300	117
Net pension expense	\$ 211	\$ 108	\$ 115	\$ 131	\$ 326	\$ 239

(In thousands)	Six Months Ended August 31					
	Pension Plan		Restoration Plan		Total	
	2012	2011	2012	2011	2012	2011
Interest cost	\$ 3,650	\$ 3,416	\$ 230	\$ 260	\$ 3,880	\$ 3,676
Expected return on plan assets	(3,796)	(3,436)			(3,796)	(3,436)
Recognized actuarial loss	600	230			600	230
Net pension expense	\$ 454	\$ 210	\$ 230	\$ 260	\$ 684	\$ 470

We made contributions of \$5.1 million to the pension plan during the six months ended August 31, 2012. We do not anticipate making any further contributions during the remainder of fiscal 2013. The expected long-term rate of return on plan assets for the pension plan was 7.75% as of February 29, 2012.

9. Debt

Revolving Credit Facility. Our \$700 million unsecured revolving credit facility (the “credit facility”) expires in August 2016. The credit facility agreement contains representations and warranties, conditions and covenants. As of August 31, 2012, we were in compliance with the covenants. Borrowings under the credit facility are available for working capital and general corporate purposes. As of August 31, 2012, \$1.1 million of short-term debt was outstanding under the credit facility and the remaining capacity was fully available to us.

Finance and Capital Lease Obligations. Finance and capital lease obligations relate primarily to superstores subject to sale-leaseback transactions. The leases were structured at varying interest rates with initial lease terms ranging from 15 to 20 years with payments made monthly. Payments on the leases are recognized as interest expense and a reduction of the obligations. Obligations under finance and capital leases as of August 31, 2012, consisted of \$15.3

million classified as current portion of finance and capital lease obligations and \$345.6 million classified as finance and capital lease obligations, excluding current portion.

We must meet financial covenants in conjunction with certain of the sale-leaseback transactions. As of August 31, 2012, we were in compliance with the covenants. We have not entered into any sale-leaseback transactions since fiscal 2009.

Non-Recourse Notes Payable. The timing of principal payments on the non-recourse notes payable is based on principal collections, net of losses, on the securitized auto loan receivables. As of August 31, 2012, \$5.08 billion of non-recourse notes payable was outstanding. The outstanding balance included \$171.3 million classified as current portion of non-recourse notes payable, as this represents principal payments that have been collected, but will be distributed in the following period. The majority of the non-recourse notes payable accrue interest at fixed rates and have scheduled maturities through December 2018, but may mature earlier or later, depending upon the repayment rate of the underlying auto loan receivables.

During the second quarter of fiscal 2013, we renewed our \$800 million warehouse facility that was scheduled to expire in August 2012 for an additional 364-day term. As of August 31, 2012, the combined warehouse facility limit was \$1.6 billion. As of that date, \$1.07 billion of auto loan receivables was funded in the warehouse facilities and unused warehouse capacity totaled \$534.0 million. Of the combined warehouse facility limit, \$800 million will expire in February 2013 and \$800 million will expire in August 2013. The return requirements of the warehouse facility investors could fluctuate significantly depending on market conditions. At renewal, the cost, structure and capacity of the facilities could change. These changes could have a significant effect on our funding costs.

The securitization agreements related to the warehouse facilities include various financial covenants and performance triggers. As of August 31, 2012, we were in compliance with the financial covenants and the securitized receivables were in compliance with the performance triggers. If these financial covenants and/or thresholds are not met, we could be unable to continue to securitize receivables through the warehouse facilities. In addition, the warehouse facility investors could charge us a higher rate of interest and could have us replaced as servicer. Further, we could be required to deposit collections on the securitized receivables with the warehouse facility agents on a daily basis and deliver executed lockbox agreements to the warehouse facility agents.

See Notes 2 and 4 for additional information on the related securitized auto loan receivables.

10. Share-Based Compensation

We maintain long-term incentive plans for management, key employees and the nonemployee members of our board of directors. The plans allow for the granting of equity-based compensation awards, including nonqualified stock options, incentive stock options, stock appreciation rights, restricted stock awards, stock- and cash-settled restricted stock units, stock grants or a combination of awards. To date, we have not awarded any incentive stock options.

The majority of associates who receive share-based compensation awards primarily receive cash-settled restricted stock units. Senior management and other key associates receive awards of nonqualified stock options and stock-settled restricted stock units. Nonemployee directors receive awards of nonqualified stock options and stock grants.

Nonqualified Stock Options. Nonqualified stock options are awards that allow the recipient to purchase shares of our common stock at a fixed price. Stock options are granted at an exercise price equal to the fair market value of our common stock on the grant date. The stock options generally vest annually in equal amounts over periods of one to four years. These options are subject to forfeiture and expire no later than ten years after the date of the grant.

Cash-Settled Restricted Stock Units. Also referred to as restricted stock units, or RSUs, these are awards that entitle the holder to a cash payment equal to the fair market value of a share of our common stock for each unit granted. Conversion generally occurs at the end of a three-year vesting period. However, the cash payment per RSU will not be greater than 200% or less than 75% of the fair market value of a share of our common stock on the grant date. RSUs are liability awards that are subject to forfeiture and do not have voting rights.

Stock-Settled Restricted Stock Units. Also referred to as market stock units, or MSUs, these are awards to eligible key associates that are converted into between zero and two shares of common stock for each unit granted. Conversion generally occurs at the end of a three-year vesting period. The conversion ratio is calculated by dividing the average closing price of our stock during the final forty trading days of the three-year vesting period by our stock price on the grant date, with the resulting quotient capped at two. This quotient is then multiplied by the number of MSUs granted to yield the number of shares awarded. MSUs are subject to forfeiture and do not have voting rights.

Restricted Stock. Restricted stock awards are awards of our common stock that are subject to specified restrictions and a risk of forfeiture. The restrictions typically lapse three years from the grant date. Participants holding restricted stock are entitled to vote on matters submitted to holders of our common stock for a vote. No restricted stock awards have been granted since fiscal 2009, and no awards were outstanding as of February 29, 2012. We realized related tax benefits of \$10.9 million from the vesting of restricted stock during the six months ended August 31, 2011.

Composition of Share-Based Compensation Expense

(In thousands)	Three Months Ended		Six Months Ended	
	August 31		August 31	
	2012	2011	2012	2011
Cost of sales	\$ 682	\$ 414	\$ 1,097	\$ 689
CarMax Auto Finance income	651	506	1,129	862
Selling, general and administrative expenses	13,559	10,638	28,483	25,241
Share-based compensation expense, before income taxes	\$ 14,892	\$ 11,558	\$ 30,709	\$ 26,792

Composition of Share-Based Compensation Expense – By Grant Type

(In thousands)	Three Months Ended August 31		Six Months Ended August 31	
	2012	2011	2012	2011
Nonqualified stock options	\$ 5,528	\$ 4,899	\$ 14,241	\$ 12,885
Cash-settled restricted stock units	5,692	3,520	8,392	6,867
Stock-settled restricted stock units	2,844	2,292	7,023	5,838
Employee stock purchase plan	278	265	503	489
Stock grants to non-employee directors	550	550	550	550
Restricted stock		32		163
Share-based compensation expense, before income taxes	\$ 14,892	\$ 11,558	\$ 30,709	\$ 26,792

We recognize compensation expense for stock options, MSUs and restricted stock on a straight-line basis (net of estimated forfeitures) over the requisite service period, which is generally the vesting period of the award. The variable expense associated with RSUs is recognized over their vesting period (net of estimated forfeitures) and is calculated based on the volume-weighted average price of our common stock on the last trading day of each reporting period. The total costs for matching contributions for our employee stock purchase plan are included in share-based compensation expense. There were no capitalized share-based compensation costs as of or for the six months ended August 31, 2012 or 2011.

Stock Option Activity

(Shares and intrinsic value in thousands)	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Aggregate	
			Contractual Life (Years)	Intrinsic Value
Outstanding as of February 29, 2012	12,578	\$ 19.84		
Options granted	2,234	31.60		
Options exercised	(792)	15.86		
Options forfeited or expired	(33)	24.70		
Outstanding as of August 31, 2012	13,987	\$ 21.93	3.8	\$ 127,631
Exercisable as of August 31, 2012	9,221	\$ 18.61	2.9	\$ 112,031

For the six months ended August 31, 2012 and 2011, we granted nonqualified options to purchase 2,233,624 and 1,933,690 shares of common stock, respectively. The total cash received as a result of stock option exercises for the six months ended August 31, 2012 and 2011, was \$12.6 million and \$14.0 million, respectively. We settle stock option exercises with authorized but unissued shares of our common stock. The total intrinsic value of options

exercised for the six months ended August 31, 2012 and 2011, was \$12.2 million and \$13.2 million, respectively. We realized related tax benefits of \$4.9 million and \$5.2 million during the six months ended August 31, 2012, and 2011, respectively.

Outstanding Stock Options

Range of Exercise Prices	As of August 31, 2012				Options Exercisable	
	Options Outstanding	Weighted		Weighted		
(Shares in thousands)	Number	Average Remaining	Weighted Average	Number	Weighted Average	
of Shares	Contractual Life (Years)	Exercise Price	Exercise Price	of Shares	Exercise Price	
\$ 7.14 - \$ 10.75	482	0.6	\$ 7.15	482	\$ 7.15	
\$ 11.43	2,196	3.6	\$ 11.43	1,618	\$ 11.43	
\$ 13.19 - \$ 14.81	2,044	2.3	\$ 13.83	2,044	\$ 13.83	
\$ 14.86 - \$ 19.82	2,033	2.4	\$ 19.22	2,033	\$ 19.22	
\$ 19.98 - \$ 25.12	1,304	1.9	\$ 24.78	1,233	\$ 24.84	
\$ 25.39 - \$ 30.24	1,851	4.5	\$ 25.56	1,019	\$ 25.41	
\$ 31.76 - \$ 32.05	2,189	6.6	\$ 31.76	140	\$ 31.77	
\$ 32.69 - \$ 33.11	1,888	5.6	\$ 32.70	652	\$ 32.70	
Total	13,987	3.8	\$ 21.93	9,221	\$ 18.61	

For stock options, the fair value of each award is estimated as of the date of grant using a binomial valuation model. In computing the value of the option, the binomial model considers characteristics of fair-value option pricing that are not available for consideration under a closed-form valuation model (for example, the Black-Scholes model), such as the contractual term of the option, the probability that the option will be exercised prior to the end of its contractual life and the probability of termination or retirement of the option holder. For this reason, we believe that the binomial model provides a fair value that is more representative of actual experience and future expected experience than the value calculated using a closed-form model. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by the recipients of share-based awards.

The weighted average fair value per share at the date of grant for options granted during the six months ended August 31, 2012 and 2011, was \$12.68 and \$13.84, respectively. The unrecognized compensation costs related to nonvested options totaled \$41.9 million as of August 31, 2012. These costs are expected to be recognized on a straight-line basis over a weighted average period of 2.5 years.

Assumptions Used to Estimate Option Values

	Six Months Ended August 31	
	2012	2011
Dividend yield	0.0 %	0.0 %
Expected volatility factor ⁽¹⁾	32.4 % - 51.4 %	34.8 % - 51.0 %
Weighted average expected volatility	49.4 %	49.3 %
Risk-free interest rate ⁽²⁾	0.02 % - 2.0 %	0.01 % - 3.5 %

Expected term (in years) ⁽³⁾	4.7	4.6
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(1) Measured using historical daily price changes of our stock for a period corresponding to the term of the options and the implied volatility derived from the market prices of traded options on our stock.

(2) Based on the U.S. Treasury yield curve in effect at the time of grant.

(3) Represents the estimated number of years that options will be outstanding prior to exercise.

Cash-Settled Restricted Stock Unit Activity

(Units in thousands)	Weighted Average	
	Number of Units	Grant Date Fair Value
Outstanding as of February 29, 2012	1,915	\$ 21.76
Stock units granted	644	\$ 31.76
Stock units vested and converted	(780)	\$ 11.53
Stock units cancelled	(58)	\$ 28.68
Outstanding as of August 31, 2012	1,721	\$ 29.90

For the six months ended August 31, 2012 and 2011, we granted RSUs of 644,232 units and 575,380 units, respectively. The initial fair market value per unit at the date of grant for the RSUs granted during the six months ended August 31, 2012 and 2011, was \$31.76 and \$32.69, respectively. The RSUs are cash-settled upon vesting. For the six months ended August 31, 2012, we paid out \$17.9 million before payroll tax withholdings upon the vesting of restricted stock units and realized tax benefits of \$7.1 million.

Expected Cash Settlement Range Upon Restricted Stock Unit Vesting

(In thousands)	As of August 31, 2012	
	Minimum	Maximum ⁽¹⁾
Fiscal 2014	\$ 10,583	\$ 28,220
Fiscal 2015	11,497	30,659
Fiscal 2016	12,645	33,721
Total expected cash settlements	\$ 34,725	\$ 92,600

⁽¹⁾ Net of estimated forfeitures.

Stock-Settled Restricted Stock Unit Activity

(Units in thousands)	Weighted Average	
	Number of Units	Grant Date Fair Value
Outstanding as of February 29, 2012	950	\$ 31.12
Stock units granted	347	\$ 40.36

Stock units vested and converted	(387)	\$ 16.67
Stock units cancelled	(6)	\$ 40.77
Outstanding as of August 31, 2012	904	\$ 41.00

For the six months ended August 31, 2012 and 2011, we granted MSUs of 346,551 units and 292,946 units, respectively. The fair value per unit at the date of grant for MSUs granted during the six months ended August 31, 2012 and 2011, was \$40.36 and \$45.58, respectively. The fair values were determined using a Monte-Carlo simulation and were based on the expected market price of our common stock on the vesting date and the expected number of converted common shares. We realized related tax benefits of \$9.5 million for the six months ended August 31, 2012, from the vesting of market stock units. The unrecognized compensation costs related to nonvested MSUs totaled \$19.7 million as of August 31, 2012. These costs are expected to be recognized on a straight-line basis over a weighted average period of 1.7 years.

11. Net Earnings per Share

Basic net earnings per share is computed by dividing net earnings available for basic common shares by the weighted average common shares outstanding during the period. Diluted net earnings per share is computed by dividing net earnings available for diluted common shares by the sum of weighted average common shares outstanding and dilutive

potential common shares. For periods with outstanding participating securities, diluted net earnings per share reflects the more dilutive of the “if converted” treasury stock method or the two-class method. For periods with no outstanding participating securities, diluted net earnings per share is calculated using the “if-converted” treasury stock method. There were no outstanding participating securities during the three months and six months ended August 31, 2012.

Nonvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and should be included in the computation of net earnings per share pursuant to the two-class method. Our restricted stock awards are considered participating securities because they contain nonforfeitable rights to dividends and are included in the computation of net earnings per share pursuant to the two-class method. Nonvested MSUs do not receive nonforfeitable dividend equivalent rights, and therefore, are not considered participating securities. RSUs are nonparticipating, non-equity instruments, and therefore, are excluded from net earnings per share calculations.

Basic and Dilutive Net Earnings Per Share Reconciliations

(In thousands except per share data)	Three Months Ended August 31		Six Months Ended August 31	
	2012	2011 ⁽¹⁾	2012	2011 ⁽¹⁾
Net earnings	\$ 111,636	\$ 111,154	\$ 232,382	\$ 236,654
Less net earnings allocable to restricted stock				190
Net earnings available for basic common shares	111,636	111,154	232,382	236,464
Adjustment for dilutive potential common shares				24
Net earnings available for diluted common shares	\$ 111,636	\$ 111,154	\$ 232,382	\$ 236,488
Weighted average common shares outstanding	228,366	226,300	228,069	225,935
Dilutive potential common shares:				
Stock options	2,958	3,575	3,196	3,764
Stock-settled restricted stock units	372	806	484	780
Weighted average common shares and dilutive potential common shares	231,696	230,681	231,749	230,479
Basic net earnings per share	\$ 0.49	\$ 0.49	\$ 1.02	\$ 1.05
Diluted net earnings per share	\$ 0.48	\$ 0.48	\$ 1.00	\$ 1.03

⁽¹⁾ As discussed in Note 2, fiscal 2012 reflects the revisions to correct our accounting for sale-leaseback transactions.

Certain weighted-average options to purchase shares of common stock were outstanding and not included in the calculation of diluted net earnings per share because their inclusion would have been antidilutive. For the three months ended August 31, 2012 and 2011, weighted average options to purchase 4,266,794 shares and 3,255,021 shares of common stock, respectively, were not included. For the six months ended August 31, 2012 and 2011, weighted-average options to purchase 3,678,076 shares and 2,912,288 shares of common stock, respectively, were not

included.

12. Accumulated Other Comprehensive Loss

(In thousands, net of income taxes)	Unrecognized Actuarial (Losses) Gains	Unrecognized Hedge Losses	Total Accumulated Other Comprehensive Loss
Balance as of February 29, 2012	\$ (39,774)	\$ (22,685)	\$ (62,459)
Amortization recognized in net pension expense	449		449
Effective portion of changes in fair value		4,634	4,634
Reclassifications to CarMax Auto Finance income		3,965	3,965
Balance as of August 31, 2012	\$ (39,325)	\$ (14,086)	\$ (53,411)

Changes in the funded status of our retirement plans and the effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges are recognized in accumulated other comprehensive loss. The cumulative balances are net of deferred taxes of \$32.3 million as of August 31, 2012, and \$24.0 million as of February 29, 2012. In the second quarter of fiscal 2013, a \$8.5 million tax benefit adjustment related to prior years was made to the effective portion of changes in fair value and a \$1.3 million tax provision adjustment related to the first quarter of fiscal 2013 was made to the reclassifications to CarMax Auto Finance income. The adjustments are not considered material to any of the periods presented.

13. Contingent Liabilities

On April 2, 2008, Mr. John Fowler filed a putative class action lawsuit against CarMax Auto Superstores California, LLC and CarMax Auto Superstores West Coast, Inc. in the Superior Court of California, County of Los Angeles. Subsequently, two other lawsuits, Leena Areso et al. v. CarMax Auto Superstores California, LLC and Justin Weaver v. CarMax Auto Superstores California, LLC, were consolidated as part of the Fowler case. The allegations in the consolidated case involved: (1) failure to provide meal and rest breaks or compensation in lieu thereof; (2) failure to pay wages of terminated or resigned employees related to meal and rest breaks and overtime; (3) failure to pay overtime; (4) failure to comply with itemized employee wage statement provisions; and (5) unfair competition/California's Labor Code Private Attorney General Act. The putative class consisted of sales consultants, sales managers, and other hourly employees who worked for the company in California from April 2, 2004, to the present. On May 12, 2009, the court dismissed all of the class claims with respect to the sales manager putative class. On June 16, 2009, the court dismissed all claims related to the failure to comply with the itemized employee wage statement provisions. The court also granted CarMax's motion for summary adjudication with regard to CarMax's alleged failure to pay overtime to the sales consultant putative class. The plaintiffs appealed the court's ruling regarding the sales consultant overtime claim. On May 20, 2011, the California Court of Appeal affirmed the court's ruling in favor of CarMax. The plaintiffs filed a Petition of Review with the California Supreme Court, which was denied. As a result, the plaintiffs' overtime claims are no longer part of the case.

The claims currently remaining in the lawsuit regarding the sales consultant putative class are: (1) failure to provide meal and rest breaks or compensation in lieu thereof; (2) failure to pay wages of terminated or resigned employees related to meal and rest breaks; and (3) unfair competition/California's Labor Code Private Attorney General Act. On June 16, 2009, the court entered a stay of these claims pending the outcome of a California Supreme Court case involving unrelated third parties but related legal issues. Subsequently, CarMax moved to lift the stay and compel the plaintiffs' remaining claims into arbitration on an individualized basis, which the court granted on November 21, 2011. Plaintiffs filed an appeal that is currently pending with the California Court of Appeal. The Fowler lawsuit seeks compensatory and special damages, wages, interest, civil and statutory penalties, restitution, injunctive relief and the recovery of attorneys' fees. We are unable to make a reasonable estimate of the amount or range of loss that could result from an unfavorable outcome in these matters.

We are involved in various other legal proceedings in the normal course of business. Based upon our evaluation of information currently available, we believe that the ultimate resolution of any such proceedings will not have a material effect, either individually or in the aggregate, on our financial condition, results of operations or cash flows.

ITEM 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is provided as a supplement to, and should be read in conjunction with, our audited consolidated financial statements, the accompanying notes and the MD&A included in our Annual Report on Form 10-K for the fiscal year ended February 29, 2012 ("fiscal 2012"), as well as our consolidated financial statements and the accompanying notes included in Item 1 of this Form 10-Q. Note references are to the notes to consolidated financial statements included in Item 1. Certain prior year amounts have been reclassified to conform to the current year's presentation. All references to net earnings per share are to diluted net earnings per share. Amounts and percentages may not total due to rounding.

We have revised the consolidated financial statements for fiscal 2012 interim periods to reflect the correction made in fiscal 2012 in our accounting for sale-leaseback transactions. See Note 2 for additional information.

In this discussion, "we," "our," "us," "CarMax," "CarMax, Inc." and "the company" refer to CarMax, Inc. and its wholly owned subsidiaries, unless the context requires otherwise.

BUSINESS OVERVIEW

General

CarMax is the nation's largest retailer of used vehicles. We pioneered the used car superstore concept, opening our first store in 1993. Our strategy is to revolutionize the auto retailing market by addressing the major sources of customer dissatisfaction with traditional auto retailers and to maximize operating efficiencies through the use of standardized operating procedures and store formats enhanced by sophisticated, proprietary management information systems. As of August 31, 2012, we operated 113 used car superstores in 56 markets, comprising 44 mid-sized markets, 11 large markets and 1 small market. We also operated four new car franchises. During fiscal 2012, we sold 408,080 used cars, representing 98% of the total 415,759 vehicles we sold at retail.

We believe the CarMax consumer offer is distinctive within the automobile retailing marketplace. Our offer provides customers the opportunity to shop for vehicles the same way they shop for items at other "big box" retailers. Our consumer offer is structured around four customer benefits: low, no-haggle prices; a broad selection; high quality vehicles; and a customer-friendly sales process. Our website, carmax.com, is a valuable tool for communicating the CarMax consumer offer, a sophisticated search engine and an efficient channel for customers who prefer to commence their shopping online. Our financial results are driven by retailing used vehicles and associated items including vehicle financing, extended service plans ("ESPs"), a guaranteed asset protection ("GAP") product and vehicle repair service. GAP is designed to cover the unpaid balance on an auto loan in the event of a total loss of the vehicle or

unrecovered theft.

We also generate revenues, income and cash flows from the sale of vehicles purchased through our appraisal process that do not meet our retail standards. These vehicles are sold through on-site wholesale auctions. Wholesale auctions are generally held on a weekly or bi-weekly basis, and as of August 31, 2012, we conducted auctions at 54 used car superstores. During fiscal 2012, we sold 316,649 wholesale vehicles. On average, the vehicles we wholesale are approximately 10 years old and have more than 100,000 miles. Participation in our wholesale auctions is restricted to licensed automobile dealers, the majority of whom are independent dealers and licensed wholesalers.

CarMax provides financing to qualified retail customers through CarMax Auto Finance (“CAF”), our finance operation, and our arrangements with several industry-leading financial institutions. The third-party providers purchasing subprime finance contracts generally purchase these contracts at a discount, while providers purchasing prime and non-prime finance contracts generally pay us a fixed, prenegotiated fee per contract. We periodically test additional third-party providers. We have no recourse liability on retail installment contracts arranged with third-party providers.

We offer financing through CAF to qualified customers purchasing vehicles at CarMax. CAF utilizes proprietary customized scoring models based upon the credit history of the customer, along with CAF’s historical experience, to predict the likelihood of customer repayment. CAF offers customers an array of competitive rates and terms, allowing them to choose the ones that

best fit their needs. In addition, customers are permitted to refinance or pay off their contract with CAF or a third-party provider within three business days of a purchase without incurring any finance or related charges. We randomly test different credit offers and closely monitor acceptance rates and 3-day payoffs to assess market competitiveness. After the effect of 3 day payoffs and vehicle returns, CAF financed approximately 37% of our retail vehicle unit sales in the first half of fiscal 2013. As of August 31, 2012, CAF serviced approximately 430,000 customer accounts in its \$5.34 billion portfolio of managed receivables.

We sell ESPs and GAP on behalf of unrelated third parties who are the primary obligors. We have no contractual liability to the customer under these third-party plans. ESP revenue represents commissions received on the sale of ESPs and GAP from the unrelated third parties.

Over the long term, we believe the primary driver for earnings growth will be vehicle unit sales growth from both new stores and stores included in our comparable store base. We target a dollar range of gross profit per used unit sold. The gross profit dollar target for an individual vehicle is based on a variety of factors, including its probability of sale and its mileage relative to its age; however, it is not primarily based on the vehicle's selling price. Our ability to quickly adjust appraisal offers to be consistent with the broader market trade-in trends and our inventory management practices reduce our exposure to the inherent continual fluctuation in used vehicle values and contribute to our ability to manage gross profit dollars per unit. We employ a volume-based strategy, and we systematically mark down individual vehicle prices based on proprietary pricing algorithms in order to appropriately balance sales trends, inventory turns and gross profit achievement.

In December 2008, we temporarily suspended store growth due to the weak economic and sales environment. We resumed store growth in fiscal 2011, opening three superstores that year and five superstores in fiscal 2012. We plan to open 10 superstores in fiscal 2013 and between 10 and 15 superstores in each of the following 3 fiscal years. While we have more than 100 superstores, we are still in the midst of the national rollout of our retail concept, and as of August 31, 2012, we had used car superstores located in markets that comprised approximately 51% of the U.S. population.

The principal challenges we face in expanding our store base include our ability to build our management bench strength to support our store growth and our ability to procure suitable real estate at favorable terms. We staff each newly opened store with associates who have extensive CarMax training. Therefore, we must recruit, train and develop managers and associates to fill the pipeline necessary to support future store openings.

Fiscal 2013 Second Quarter Highlights

§ Net sales and operating revenues increased 7% to \$2.76 billion from \$2.59 billion in the second quarter of fiscal 2012, while net earnings were relatively unchanged at \$111.6 million, or \$0.48 per share, compared with \$111.2

million, or \$0.48 per share, in the prior year period.

- § Total used vehicle revenues increased 9% to \$2.19 billion from \$2.01 billion in the second quarter of fiscal 2012. Total used vehicle unit sales rose 8%, reflecting the combination of a 5% increase in comparable store used unit sales together with sales from newer stores not yet included in the comparable store base. The used vehicle average selling price was similar to the prior year's quarter.
- § Total wholesale vehicle revenues declined 5% to \$437.1 million from \$457.9 million in the second quarter of fiscal 2012. The reduction in wholesale vehicle revenues resulted from 2% declines in both unit sales and the wholesale vehicle average selling price. Appraisal traffic was higher than in the prior year period; however, our appraisal buy rate was lower.
- § Total gross profit increased 4% to \$368.0 million compared with \$354.3 million in the second quarter of fiscal 2012, as an 8% increase in used vehicle gross profit more than offset reductions in wholesale, new and other gross profit.
- § CAF income increased 19% to \$75.7 million compared with \$63.8 million in the second quarter of fiscal 2012. The improvement in CAF income was primarily due to the 14% increase in average managed receivables. The increase in average managed receivables reflected the growth in CAF origination volume throughout fiscal 2012 and the first half of fiscal 2013 as we transitioned back to a pre-recession origination strategy, as well as higher average selling prices and retail unit sales growth over this period.
- § Selling, general and administrative ("SG&A") expenses increased 11% to \$254.7 million from \$229.9 million in the second quarter of fiscal 2012. SG&A per retail unit increased 2% to \$2,241 versus \$2,197 in the prior year's quarter. The increase in SG&A expenses primarily reflected the 8% increase in our store base since the beginning of last year's second quarter and costs associated with this year's higher rate of store growth.
- § In the first half of the fiscal year, net cash used in operating activities totaled \$285.9 million in fiscal 2013 compared with \$75.9 million in fiscal 2012. These amounts included increases in auto loan receivables of \$377.5 million and \$388.3 million, respectively. The majority of the increases in auto loan receivables are accompanied by increases in non-recourse notes payable, which are reflected as cash provided by financing activities.

CRITICAL ACCOUNTING POLICIES

For information on critical accounting policies, see “Critical Accounting Policies” in MD&A included in Item 7 of the Annual Report on Form 10-K for the fiscal year ended February 29, 2012. These policies relate to financing and securitization transactions, revenue recognition and income taxes.

RESULTS OF OPERATIONS

Net Sales And Operating Revenues

(In millions)	Three Months Ended August 31				Six Months Ended August 31			
	2012	%	2011	%	2012	%	2011	%
Used vehicle sales	\$ 2,192.0	79.5	\$ 2,015.0	77.9	\$ 4,380.9	79.2	\$ 4,086.5	77.6
New vehicle sales	61.4	2.2	46.9	1.8	116.9	2.1	108.7	2.1
Wholesale vehicle sales	437.1	15.8	457.9	17.7	904.8	16.4	935.7	17.8
Other sales and revenues:								
Extended service plan revenues	52.9	1.9	44.9	1.7	104.2	1.9	91.3	1.7
Service department sales	26.8	1.0	26.0	1.0	51.6	0.9	51.2	1.0
Third-party finance fees, net	(12.1)	(0.4)	(2.9)	(0.1)	(25.9)	(0.5)	(6.2)	(0.1)
Total other sales and revenues	67.6	2.5	68.1	2.6	129.9	2.3	136.3	2.6
Total net sales and operating revenues	\$ 2,758.0	100.0	\$ 2,587.8	100.0	\$ 5,532.4	100.0	\$ 5,267.2	100.0

Unit Sales

	Three Months Ended August 31		Six Months Ended August 31	
	2012	2011	2012	2011
Used vehicles	111,316	102,825	223,607	211,336
New vehicles	2,352	1,798	4,459	4,233
Wholesale vehicles	82,771	84,885	166,312	169,947

Average Selling Prices

	Three Months Ended August 31		Six Months Ended August 31	
	2012	2011	2012	2011
Used vehicles	\$ 19,494	\$ 19,408	\$ 19,389	\$ 19,148

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New vehicles	\$ 25,982	\$ 25,927	\$ 26,073	\$ 25,559
Wholesale vehicles	\$ 5,133	\$ 5,249	\$ 5,292	\$ 5,359

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Used Vehicle Sales Changes

	Three Months		Six Months	
	Ended	Ended	Ended	Ended
	August 31	August 31	August 31	August 31
	2012	2011	2012	2011
Used vehicle units	8 %	(1)%	6 %	3 %
Used vehicle dollars	9 %	7 %	7 %	10 %

Comparable store used unit sales growth is one of the key drivers of our profitability. A store is included in comparable store retail sales in the store's fourteenth full month of operation.

Comparable Store Used Vehicle Sales Changes

	Three Months		Six Months	
	Ended	Ended	Ended	Ended
	August 31	August 31	August 31	August 31
	2012	2011	2012	2011
Used vehicle units	5 %	(2)%	2 %	2 %
Used vehicle dollars	5 %	5 %	4 %	8 %

Change in Used Car Superstore Base

	Three Months		Six Months	
	Ended	Ended	Ended	Ended
	August 31	August 31	August 31	August 31
	2012	2011	2012	2011
Used car superstores, beginning of period	110	105	108	103
Superstore openings	3	1	5	3
Used car superstores, end of period	113	106	113	106

Used Vehicle Sales. The 9% increase in used vehicle revenues in the second quarter of fiscal 2013 was primarily the result of an 8% increase in used unit sales. The increase in used unit sales included a 5% increase in comparable store used unit sales, together with sales from newer stores not yet included in the comparable store base. The comparable store unit growth was driven by improved conversion, which was supported by better credit offers and continued strong in-store execution. The used vehicle average retail selling price was similar to the prior year's second quarter.

The overall supply of late-model used vehicles being remarketed has remained constrained following three years of new car industry sales at rates significantly below pre-recession levels. During most of this period, wholesale vehicle

industry values rose, which increased our vehicle acquisition costs and average selling prices compared with pre-recession periods. We believe the constrained supply of late-model used vehicles and the resulting increase in selling prices has had an adverse effect on our sales.

The 7% increase in used vehicle revenues in the first half of fiscal 2013 resulted from a 6% increase in unit sales and a 1% increase in average retail selling price. The 6% increase in unit sales included a 2% increase in comparable store used unit sales, together with sales from newer stores not yet included in the comparable store base. Similar to the second quarter, the improvement in comparable store unit growth was driven by improved conversion. The increase in used vehicle average retail selling price in the first half of the year primarily reflected the net effect of shifts in our sales mix by vehicle age. Our sales mix will vary from period to period, reflecting changing consumer preferences.

Wholesale Vehicle Sales. We seek to build customer satisfaction by offering high-quality retail vehicles. Fewer than half of the vehicles acquired from consumers through the appraisal purchase process meet our standards for reconditioning and subsequent retail sale. Those vehicles that do not meet our standards are sold through on-site wholesale auctions. Our wholesale auction prices usually reflect the trends in the general wholesale market for the types of vehicles we sell, although they can also be affected by changes in vehicle mix or the average age, mileage or condition of the vehicles sold.

The 5% decline in wholesale vehicle revenues in the second quarter of fiscal 2013 resulted from 2% decreases in both wholesale unit sales and the wholesale vehicle average selling price. The decrease in unit sales reflected a challenging year-over-year comparison, following increases of 23% and 20% in the second quarter of the two previous fiscal years. Appraisal traffic in the current quarter was higher than in the prior year; however, our appraisal buy rate was lower, which we believe reflected the effect of moderating wholesale vehicle valuations in recent months.

The 3% decline in wholesale vehicle revenues in the first half of fiscal 2013 resulted from a 2% decrease in wholesale unit sales and a 1% decline in wholesale vehicle average selling price. Similar to the second quarter, appraisal traffic in the first half of the year was higher than in fiscal 2012; however, our appraisal buy rate declined.

Other Sales and Revenues. Other sales and revenues include commissions on the sale of ESPs and GAP (reported in ESP revenues), service department sales and third-party finance fees, net. For providers who pay us a fixed fee per vehicle financed, this fee varies reflecting the differing levels of credit risk exposure. The third-party providers who purchase subprime finance contracts generally purchase these contracts at a discount, which is reflected as an offset to finance fee revenues received on other third-party finance contracts.

Other sales and revenues declined 1% in the second quarter of fiscal 2013 compared with the prior year period, as an increase in ESP revenues was more than offset by a reduction in net third-party finance fees caused by a mix shift among providers. Third party subprime providers originated 14% of used vehicle unit sales in the current quarter compared with 7% in the prior year's second quarter. ESP revenues climbed 18% largely due to the growth in our retail vehicle unit sales and an increase in ESP penetration, as well as a payment from a third-party ESP administrator based on favorable claims experience.

Other sales and revenues declined 5% in the first half of fiscal 2013 compared with the prior year period. Similar to the second quarter, growth in ESP revenues was more than offset by a reduction in net third-party finance fees. Third-party subprime finance providers originated 15% of used vehicle unit sales in the first half of fiscal 2013 compared with 8% in fiscal 2012. ESP revenues increased 14% in the first half of the year primarily reflecting the growth in our retail vehicle unit sales and an increase in ESP penetration.

Seasonality. Historically, our business has been seasonal. Typically, our superstores experience their strongest traffic and sales in the spring and summer quarters. Sales are typically slowest in the fall quarter, when used vehicles generally experience proportionately more of their annual depreciation. We believe this is partly the result of a decline in customer traffic, as well as discounts on model year closeouts that can pressure pricing for late-model used vehicles. Customer traffic generally tends to slow in the fall as the weather changes and as customers shift their spending priorities. We typically experience an increase in subprime traffic and sales in February and March, coincident with tax refund season.

Gross Profit

	Three Months Ended		Six Months Ended	
	August 31		August 31	
(In millions)	2012	2011	2012	2011
Used vehicle gross profit	\$ 241.8	\$ 224.0	\$ 491.2	\$ 465.2

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New vehicle gross profit	1.6	1.7	3.2	3.1
Wholesale vehicle gross profit	75.1	78.8	157.0	165.0
Other gross profit	49.5	49.8	98.6	104.0
Total	\$ 368.0	\$ 354.3	\$ 749.9	\$ 737.4

Gross Profit Per Unit

	Three Months Ended				Six Months Ended			
	August 31		August 31		August 31		August 31	
	2012	2011	2012	2011	2012	2011	2012	2011
	\$ per unit	% ⁽²⁾	\$ per unit	% ⁽²⁾	\$ per unit	% ⁽²⁾	\$ per unit	% ⁽²⁾
	(1)		(1)		(1)		(1)	
Used vehicle gross profit	\$ 2,172	11.0	\$ 2,178	11.1	\$ 2,197	11.2	\$ 2,201	11.4
New vehicle gross profit	\$ 676	2.6	\$ 948	3.6	\$ 713	2.7	\$ 744	2.9
Wholesale vehicle gross profit	\$ 907	17.2	\$ 929	17.2	\$ 944	17.3	\$ 971	17.6
Other gross profit	\$ 436	73.3	\$ 476	73.1	\$ 432	75.9	\$ 482	76.3
Total gross profit	\$ 3,237	13.3	\$ 3,386	13.7	\$ 3,288	13.6	\$ 3,421	14.0

(1) Calculated as category gross profit divided by its respective units sold, except the other and total categories, which are divided by total retail units sold.

(2) Calculated as a percentage of its respective sales or revenue.

Used Vehicle Gross Profit. Used vehicle gross profit increased 8% in the second quarter and 6% in the first half of fiscal 2013. In both periods, the improvement was driven by corresponding increases in used unit sales. On a year-over-year basis, used vehicle gross profit per unit was virtually unchanged, at \$2,172 per unit in the second quarter compared with \$2,178 per unit in the prior year quarter, and at \$2,197 per unit in the first half of fiscal 2013 compared with \$2,201 per unit in the corresponding period of fiscal 2012. We have been able to manage to a relatively consistent gross profit per unit over the last several years.

Wholesale Vehicle Gross Profit. Wholesale vehicle gross profit declined 5% in both the second quarter and the first half of fiscal 2013. In both periods, roughly half of the reduction in wholesale gross profits was attributable to the modestly lower wholesale unit sales and half was attributable to a decline in wholesale gross profit of between \$20 and \$30 per unit. Second quarter wholesale vehicle gross profit per unit was \$907 per unit compared with \$929 per unit in the prior year period, while wholesale gross profit for the first half of the fiscal year was \$944 per unit compared with \$971 per unit in fiscal 2012.

Other Gross Profit. Other gross profit includes profits related to ESP and GAP revenues, net third-party finance fees and service department sales. We have no cost of sales related to ESP and GAP revenues or net third-party finance fees, as these represent commissions paid to us by certain third-party providers, net of the discount associated with the finance contracts purchased by subprime providers. Accordingly, changes in the relative mix of sales of these other gross profit components can affect the overall composition and amount of other gross profit.

Other gross profit fell less than 1% in the second quarter and 5% in the first half of fiscal 2013, similar to the changes in other sales and revenues for these periods.

Impact of Inflation. Historically, inflation has not been a significant contributor to results. Profitability is primarily affected by our ability to achieve targeted unit sales and gross profit dollars per vehicle rather than by changes in average selling prices. However, increases in average vehicle selling prices benefit CAF income, to the extent the average amount financed also increases.

During the last three fiscal years, we experienced a period of appreciation in used vehicle wholesale pricing. We believe the appreciation resulted, in part, from the reduced supply of late-model used vehicles in the market that was caused by the dramatic decline in new car industry sales and the associated slow down in used vehicle trade-in activity, compared with pre-recession periods. The higher wholesale values increased both our vehicle acquisition costs and our average selling prices for used and wholesale vehicles. In fiscal 2012, we also experienced inflationary increases in key reconditioning cost components, including tires and petroleum-based products.

CarMax Auto Finance Income. CAF provides financing for a portion of our used and new car retail sales. Because the purchase of a vehicle is generally reliant on the consumer's ability to obtain on-the-spot financing, it is important to our business that financing be available to creditworthy customers. While financing can also be obtained from third-party sources, we believe that total reliance on third parties can create unacceptable volatility and business

risk. Furthermore, we believe that our processes and systems, the transparency of our pricing and our vehicle quality provide a unique and ideal environment in which to procure high-quality auto loans, both for CAF and for the third-party financing providers. Generally, CAF has provided us the opportunity to realize additional profits and cash flows from auto loan receivables while managing our reliance on third-party financing sources. We also believe CAF enables us to capture additional sales.

CAF provides financing for qualified customers at competitive market rates of interest. CAF income primarily reflects the interest and fee income generated by the auto loan receivables less the interest expense associated with the debt issued to fund these receivables, a provision for estimated loan losses and direct CAF expenses.

Components of CAF Income

(In millions)	Three Months Ended August 31				Six Months Ended August 31			
	2012	% ⁽¹⁾	2011	% ⁽¹⁾	2012	% ⁽¹⁾	2011	% ⁽¹⁾
Interest margin:								
Interest and fee income	\$ 123.5	9.4	\$ 111.8	9.7	\$ 243.8	9.4	\$ 219.7	9.8
Interest expense	(23.9)	(1.8)	(26.2)	(2.3)	(49.0)	(1.9)	(54.7)	(2.4)
Total interest margin	99.6	7.6	85.6	7.5	194.8	7.5	165.0	7.3
Provision for loan losses	(12.9)	(1.0)	(10.8)	(0.9)	(22.1)	(0.9)	(9.8)	(0.4)
Total interest margin after provision for loan losses	86.7	6.6	74.8	6.5	172.7	6.7	155.2	6.9
Other (loss) income	(0.2)		0.4		(0.2)		1.1	
Direct expenses:								
Payroll and fringe benefit expense	(5.4)	(0.4)	(5.1)	(0.4)	(10.7)	(0.4)	(10.4)	(0.5)
Other direct expenses	(5.4)	(0.4)	(6.3)	(0.5)	(10.9)	(0.4)	(12.4)	(0.6)
Total direct expenses	(10.8)	(0.8)	(11.4)	(1.0)	(21.6)	(0.8)	(22.8)	(1.0)
CarMax Auto Finance income	\$ 75.7	5.8	\$ 63.8	5.6	\$ 150.9	5.8	\$ 133.5	5.9
Total average managed receivables	\$ 5,245.4		\$ 4,596.6		\$ 5,160.3		\$ 4,492.2	

⁽¹⁾ Annualized percent of total average managed receivables.

CAF income does not include any allocation of indirect costs or income. We present this information on a direct basis to avoid making arbitrary decisions regarding the indirect benefits or costs that could be attributed to CAF. Examples of indirect costs not allocated to CAF include retail store expenses and corporate expenses such as human resources, administrative services, marketing, information systems, accounting, legal, treasury and executive payroll.

CAF Origination Information

	Three Months Ended August 31 ⁽¹⁾				Six Months Ended August 31 ⁽¹⁾			
	2012		2011		2012		2011	
Net loans originated (in millions)	\$ 822.4		\$ 771.9		\$ 1,609.2		\$ 1,461.2	
Vehicle units financed	42,388		40,399		84,048		77,853	
Penetration rate ⁽²⁾	37.3	%	38.6	%	36.9	%	36.1	%
Weighted average contract rate	8.1	%	8.9	%	8.5	%	8.9	%

Weighted average term (in months)	65.9	65.7	65.7	65.5
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- (1) All information relates to loans originated net of estimated 3-day payoffs and vehicle returns.
- (2) Vehicle units financed as a percentage of total retail units sold.

CAF income increased 19% in the second quarter of fiscal 2013 and 13% in the first half of the fiscal year, primarily reflecting the growth in average managed receivables. Favorable CAF loan loss experience increased net earnings by \$0.01 per share during the first six months of fiscal 2013 compared with \$0.03 per share in the same period last year. The favorability occurred in the first quarter of both years. Despite the growth in our managed receivables, direct expenses decreased year over year, driven by operating efficiencies.

CAF's average managed receivables increased 14% in the second quarter of fiscal 2013 and 15% in the first half of the fiscal year, reflecting the growth in CAF origination volume throughout fiscal 2012 and the first half of fiscal 2013. Origination volumes have benefited from an increase in CAF's loan penetration, as we transitioned back to a pre-recession origination strategy and reduced the volume of finance contracts we were selling to third-party providers. This transition was completed in

January 2012. Our decision to retain more of the finance contracts that third-party providers had been purchasing in previous quarters primarily reflected our confidence in our ability to economically fund these loans. Originations also benefited from increased average retail selling prices, which translated into an increase in the average amount financed, and from the growth in retail unit sales during fiscal 2012 and the first half of fiscal 2013.

Total interest margin, which reflects the spread between interest and fees charged to consumers and our funding costs, improved as a percentage of average managed receivables in both the second quarter and first six months of the fiscal year compared with the respective prior year periods. The improvement was the result of our funding costs for newer originations declining more rapidly than our interest and fee income as a percentage of average managed receivables. For the past several years, CAF has benefited from historically low funding costs in the asset-backed securitization market. Rising interest rates or competitive pressure on consumer rates could result in compression in CAF's interest margin. Should this occur, the compression would be recognized over time, as loans amortize within the portfolio of managed receivables and new loans are originated.

For the second quarter, the provision for loan losses increased modestly as a percentage of average managed receivables. Low unit charge-offs and strong recovery rates continued to largely offset the effect of the change in credit mix resulting from the transition in our origination strategy. For the first half of the fiscal year, the provision for loan losses increased to 0.9% of average managed receivables from 0.4% in fiscal 2012 largely related to the charge-off favorability experienced during the first quarter of fiscal 2012, which increased net earnings by \$0.03 per share.

Allowance for Loan Losses

(In millions)	Three Months Ended August 31				Six Months Ended August 31			
	2012	% ⁽¹⁾	2011	% ⁽¹⁾	2012	% ⁽¹⁾	2011	% ⁽¹⁾
Balance as of beginning of period	\$ 46.6	0.9	\$ 34.3	0.8	\$ 43.3	0.9	\$ 38.9	0.9
Charge-offs	(24.3)		(23.2)		(44.9)		(42.5)	
Recoveries	14.3		14.3		29.0		30.0	
Provision for loan losses	12.9		10.8		22.1		9.8	
Balance as of end of period	\$ 49.5	0.9	\$ 36.2	0.8	\$ 49.5	0.9	\$ 36.2	0.8

⁽¹⁾ Percent of total ending managed receivables as of the corresponding reporting date.

The allowance for loan losses represents an estimate of the amount of net losses inherent in our portfolio of managed receivables as of the applicable reporting date and anticipated to occur during the following 12 months. The allowance is primarily based on the credit quality of the underlying receivables, historical loss trends and forecasted

forward loss curves. We also take into account recent trends in delinquencies and losses, recovery rates and the economic environment. The provision for loan losses is the periodic expense of maintaining an adequate allowance.

The allowance for loan losses increased modestly to 0.9% of managed receivables, or \$49.5 million, as of August 31, 2012, compared with 0.8%, or \$36.2 million, as of August 31, 2011. The increase in the allowance reflected the growth in managed receivables and the origination and retention of loans with greater credit risk resulting from the transition in our origination strategy, partially offset by the net effects of low unit charge-offs and a strong recovery rate relative to historical norms. We expect the allowance for loan losses as a percent of managed receivables will increase in future periods as the higher credit risk loans gradually become a larger percentage of managed receivables.

Past Due Account Information

(In millions)	As of August 31		As of February 29 or 28	
	2012	2011	2012	2011
Accounts 31+ days past due	\$ 145.7	\$ 133.6	\$ 116.5	\$ 121.3
Ending managed receivables	\$ 5,342.1	\$ 4,707.7	\$ 4,981.8	\$ 4,334.6
Past due accounts as a percentage of ending managed receivables	2.73	%	2.84	%