

AUTONATION, INC.
Form 10-Q
October 25, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)

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

For the quarterly period ended September 30, 2012

or

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

For the transition period from _____ to _____

Commission File Number: 1-13107

AutoNation, Inc.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or
organization)

73-1105145
(I.R.S. Employer Identification No.)

200 SW 1st Avenue, Fort Lauderdale, Florida
(Address of principal executive offices)
(954) 769-6000
(Registrant's telephone number, including area code)
N/A

33301
(Zip Code)

(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 No

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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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 the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes No

As of October 23, 2012, the registrant had 121,762,984 shares of common stock outstanding.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

AUTONATION, INC.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In millions, except share and per share data)

	September 30, 2012	December 31, 2011
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$98.6	\$86.6
Receivables, net	514.2	587.4
Inventory	2,142.1	1,809.2
Other current assets	203.4	193.0
Total Current Assets	2,958.3	2,676.2
PROPERTY AND EQUIPMENT, net of accumulated depreciation of \$813.0 million and \$756.8 million, respectively	2,007.7	1,950.7
GOODWILL	1,172.2	1,172.2
OTHER INTANGIBLE ASSETS, NET	213.7	217.8
OTHER ASSETS	211.1	181.9
Total Assets	\$6,563.0	\$6,198.8
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Vehicle floorplan payable - trade	\$1,559.4	\$1,362.3
Vehicle floorplan payable - non-trade	641.4	536.5
Accounts payable	218.2	202.4
Current maturities of long-term debt	28.2	12.6
Other current liabilities	386.6	348.8
Total Current Liabilities	2,833.8	2,462.6
LONG-TERM DEBT, NET OF CURRENT MATURITIES	1,864.1	1,634.4
DEFERRED INCOME TAXES	77.8	62.3
OTHER LIABILITIES	148.8	144.9
COMMITMENTS AND CONTINGENCIES (Note 10)		
SHAREHOLDERS' EQUITY:		
Preferred stock, par value \$0.01 per share; 5,000,000 shares authorized; none issued	—	—
Common stock, par value \$0.01 per share; 1,500,000,000 shares authorized; 163,562,149 shares issued at September 30, 2012, and December 31, 2011, including shares held in treasury	1.6	1.6
Additional paid-in capital	24.6	19.6
Retained earnings	2,879.8	2,646.6
Treasury stock, at cost; 41,911,670 and 27,777,625 shares held, respectively	(1,267.5	) (773.2
Total Shareholders' Equity	1,638.5	1,894.6
Total Liabilities and Shareholders' Equity	\$6,563.0	\$6,198.8
See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.		

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AUTONATION, INC.

UNAUDITED CONDENSED CONSOLIDATED INCOME STATEMENTS

(In millions, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenue:				
New vehicle	\$2,240.5	\$1,881.6	\$6,430.9	\$5,413.3
Used vehicle	936.4	911.9	2,802.6	2,630.6
Parts and service	596.8	578.0	1,799.2	1,720.0
Finance and insurance, net	147.0	121.9	422.3	349.6
Other	13.1	13.1	40.3	40.4
TOTAL REVENUE	3,933.8	3,506.5	11,495.3	10,153.9
Cost of sales:				
New vehicle	2,095.8	1,743.4	6,006.7	5,013.1
Used vehicle	863.7	845.4	2,571.7	2,407.4
Parts and service	345.0	336.1	1,043.8	988.4
Other	6.7	6.4	19.5	20.2
TOTAL COST OF SALES	3,311.2	2,931.3	9,641.7	8,429.1
Gross Profit:				
New vehicle	144.7	138.2	424.2	400.2
Used vehicle	72.7	66.5	230.9	223.2
Parts and service	251.8	241.9	755.4	731.6
Finance and insurance	147.0	121.9	422.3	349.6
Other	6.4	6.7	20.8	20.2
TOTAL GROSS PROFIT	622.6	575.2	1,853.6	1,724.8
Selling, general, and administrative expenses	435.8	411.4	1,307.3	1,236.7
Depreciation and amortization	22.9	20.9	64.9	62.7
Franchise rights impairment	—	—	4.2	—
Other expenses (income), net	0.2	(1.2)	0.6	(3.1)
OPERATING INCOME	163.7	144.1	476.6	428.5
Non-operating income (expense) items:				
Floorplan interest expense	(11.4)	(9.7)	(32.9)	(31.8)
Other interest expense	(22.2)	(16.4)	(65.2)	(48.6)
Interest income	—	—	0.2	0.6
Other income (loss), net	2.5	(2.4)	3.1	(0.2)
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES	132.6	115.6	381.8	348.5
Income tax provision	50.7	44.9	147.4	134.2
NET INCOME FROM CONTINUING OPERATIONS	81.9	70.7	234.4	214.3
Loss from discontinued operations, net of income taxes	(0.3)	—	(1.2)	(2.3)
NET INCOME	\$81.6	\$70.7	\$233.2	\$212.0
BASIC EARNINGS (LOSS) PER SHARE:				
Continuing operations	\$0.68	\$0.49	\$1.88	\$1.46
Discontinued operations	\$—	\$—	\$(0.01)	\$(0.02)
Net income	\$0.67	\$0.49	\$1.87	\$1.44

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Weighted average common shares outstanding	121.2	144.4	124.4	146.9
DILUTED EARNINGS (LOSS) PER SHARE:				
Continuing operations	\$0.66	\$0.48	\$1.85	\$1.43
Discontinued operations	\$—	\$—	\$(0.01	) \$(0.02)
Net income	\$0.66	\$0.48	\$1.84	\$1.42
Weighted average common shares outstanding	123.4	147.0	126.4	149.5
COMMON SHARES OUTSTANDING, net of treasury stock	121.7	141.4	121.7	141.4

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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AUTONATION, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

(In millions, except share data)

	Common Stock		Additional Paid-In Capital	Retained Earnings	Treasury Stock	Total
	Shares	Amount				
December 31, 2011	163,562,149	\$1.6	\$19.6	\$2,646.6	\$(773.2)	) \$1,894.6
Net income	—	—	—	233.2	—	233.2
Repurchases of common stock	—	—	—	—	(533.2)	) (533.2)
Stock-based compensation expense	—	—	15.2	—	—	15.2
Shares awarded under stock-based compensation plans, including income tax benefit of \$8.0	—	—	(10.2)	) —	38.9	28.7
September 30, 2012	163,562,149	\$1.6	\$24.6	\$2,879.8	\$(1,267.5)	) \$1,638.5

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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AUTONATION, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In millions)

	Nine Months Ended September 30,	
	2012	2011
CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES:		
Net income	\$233.2	\$212.0
Adjustments to reconcile net income to net cash provided by operating activities:		
Loss from discontinued operations	1.2	2.3
Depreciation and amortization	64.9	62.7
Amortization of debt issuance costs and discounts	4.2	3.2
Stock-based compensation expense	15.2	15.7
Deferred income tax provision	15.4	15.9
Non-cash impairment charges	0.3	—
Franchise rights impairment	4.2	—
Net gain on asset sales and dispositions	(0.2	) (3.0
Other	(2.6	) (0.2
(Increase) decrease, net of effects from business combinations and divestitures:		
Receivables	71.7	57.5
Inventory	(332.9	) 277.6
Other assets	(25.2	) (10.5
Increase (decrease), net of effects from business combinations and divestitures:		
Vehicle floorplan payable-trade, net	197.1	(336.7
Accounts payable	17.1	5.0
Other liabilities	48.8	9.3
Net cash provided by continuing operations	312.4	310.8
Net cash provided by (used in) discontinued operations	(0.7	) 0.3
Net cash provided by operating activities	311.7	311.1
CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES:		
Purchases of property and equipment	(107.8	) (113.8
Property operating lease buy-outs	(16.8	) (13.8
Proceeds from the sale of property and equipment	0.6	3.0
Proceeds from assets held for sale	11.8	9.0
Insurance recoveries on property and equipment	1.0	—
Cash used in business acquisitions, net of cash acquired	—	(64.2
Proceeds from the sale of restricted investments	0.4	—
Cash received from business divestitures, net of cash relinquished	—	4.9
Other	(3.0	) 0.2
Net cash used in continuing operations	(113.8	) (174.7
Net cash used in discontinued operations	—	—
Net cash used in investing activities	(113.8	) (174.7

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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AUTONATION, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In millions)

(Continued)

	Nine Months Ended September 30,		
	2012	2011	
CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES:			
Repurchases of common stock	(538.3	) (335.0)
Proceeds from revolving credit facility	820.0	300.0	
Payment of revolving credit facility	(920.0	) (180.0)
Proceeds from 5.5% Senior Notes due 2020	350.0	—	
Payment of 7% Senior Notes due 2014	(14.7) —	
Payment of debt issuance costs	(6.0) —	
Net proceeds from (payments of) vehicle floorplan payable - non-trade	104.9	(28.3)
Payments of mortgage facilities	(6.0	) (5.7)
Payments of capital leases	(4.5	) (0.5)
Proceeds from the exercise of stock options	20.7	66.3	
Excess tax benefit from stock-based awards	8.0	19.0	
Net cash used in continuing operations	(185.9	) (164.2)
Net cash used in discontinued operations	—	—	
Net cash used in financing activities	(185.9	) (164.2)
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	12.0	(27.8)
CASH AND CASH EQUIVALENTS at beginning of period	86.6	95.1	
CASH AND CASH EQUIVALENTS at end of period	\$98.6	\$67.3	

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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AUTONATION, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In millions, except per share data)

1. INTERIM FINANCIAL STATEMENTS

Business and Basis of Presentation

AutoNation, Inc., through its subsidiaries, is the largest automotive retailer in the United States. As of September 30, 2012, we owned and operated 261 new vehicle franchises from 215 stores located in major metropolitan markets, predominantly in the Sunbelt region of the United States. We offer a diversified range of automotive products and services, including new vehicles, used vehicles, parts and automotive repair and maintenance services (also referred to as “parts and service”), and automotive finance and insurance products (also referred to as “finance and insurance”), including the arranging of financing for vehicle purchases through third-party finance sources. For convenience, the terms “AutoNation,” “Company,” and “we” are used to refer collectively to AutoNation, Inc. and its subsidiaries, unless otherwise required by the context. Our dealership operations are conducted by our subsidiaries.

The accompanying Unaudited Condensed Consolidated Financial Statements include the accounts of AutoNation, Inc. and its subsidiaries; all significant intercompany accounts and transactions have been eliminated. The accompanying Unaudited Condensed Consolidated Financial Statements have been prepared by us pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Accordingly, certain information related to our organization, significant accounting policies, and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted. These Unaudited Condensed Consolidated Financial Statements reflect, in the opinion of management, all material adjustments (which include only normal recurring adjustments) necessary to fairly state, in all material respects, our financial position and results of operations for the periods presented.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. In preparing these financial statements, management has made its best estimates and judgments of certain amounts included in the financial statements, giving due consideration to materiality. We base our estimates and judgments on historical experience and other assumptions that we believe are reasonable. However, application of these accounting policies involves the exercise of judgment and use of assumptions as to future uncertainties and, as a result, actual results could differ materially from these estimates. We periodically evaluate estimates and assumptions used in the preparation of the financial statements and make changes on a prospective basis when adjustments are necessary. Significant estimates made by AutoNation in the accompanying Unaudited Condensed Consolidated Financial Statements include certain assumptions related to goodwill, intangible assets, long-lived assets, assets held for sale, accruals for chargebacks against revenue recognized from the sale of finance and insurance products, accruals related to self-insurance programs, certain legal proceedings, estimated tax liabilities, estimated losses from disposals of discontinued operations, and certain assumptions related to stock-based compensation.

Operating results for interim periods are not necessarily indicative of the results that can be expected for a full year. These interim financial statements should be read in conjunction with our audited consolidated financial statements and notes thereto included in our most recent Annual Report on Form 10-K.

Recent Accounting Pronouncements

Disclosures About Offsetting Assets and Liabilities

In December 2011, the Financial Accounting Standards Board (“FASB”) issued an accounting standard update that requires an entity to disclose information about offsetting and related arrangements of financial instruments and derivative instruments to enable users of its financial statements to understand the effect of these arrangements on its financial position. The amendments in this accounting standard update are effective for annual periods beginning on or after January 1, 2013, and interim periods within those annual periods. We do not expect the adoption of this accounting standard update will have a material effect on our consolidated financial statements, but it may require

certain additional disclosures.

Testing Indefinite-Lived Intangible Assets for Impairment

In July 2012, the FASB issued an accounting standard update that amends the accounting guidance on testing indefinite-lived intangible assets for impairment. The amendments in this accounting standard update are intended to reduce complexity and costs by allowing an entity the option to make a qualitative evaluation about the likelihood that an indefinite-lived intangible asset is impaired to determine whether it should perform a quantitative impairment test. The amendments also

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AUTONATION, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

enhance the consistency of impairment testing guidance among long-lived asset categories by permitting an entity to assess qualitative factors to determine whether it is necessary to calculate the asset's fair value when testing an indefinite-lived intangible asset for impairment, which is equivalent to the impairment testing requirements for other long-lived assets. The amendments in this accounting standard update are effective for interim and annual impairment tests performed for fiscal years beginning after September 15, 2012. We test indefinite-lived intangible assets for impairment annually on April 30 or more frequently when events or changes in circumstances indicate that impairment may have occurred.

2. RECEIVABLES, NET

The components of receivables, net of allowance for doubtful accounts, are as follows:

	September 30, 2012	December 31, 2011
Trade receivables	\$96.4	\$94.3
Manufacturer receivables	124.0	138.4
Other	36.3	41.4
	256.7	274.1
Less: Allowances	(3.1	) (3.0
	253.6	271.1
Contracts-in-transit and vehicle receivables	260.6	306.1
Income tax refundable (see Note 6)	—	10.2
Receivables, net	\$514.2	\$587.4

Contracts-in-transit and vehicle receivables primarily represent receivables from financial institutions for the portion of the vehicle sales price financed by our customers.

3. INVENTORY AND VEHICLE FLOORPLAN PAYABLE

The components of inventory are as follows:

	September 30, 2012	December 31, 2011
New vehicles	\$1,722.5	\$1,397.1
Used vehicles	287.6	286.3
Parts, accessories, and other	132.0	125.8
	\$2,142.1	\$1,809.2

The components of vehicle floorplan payable are as follows:

	September 30, 2012	December 31, 2011
Vehicle floorplan payable - trade	\$1,559.4	\$1,362.3
Vehicle floorplan payable - non-trade	641.4	536.5
	\$2,200.8	\$1,898.8

Vehicle floorplan payable-trade reflects amounts borrowed to finance the purchase of specific new vehicle inventories with the corresponding manufacturers' captive finance subsidiaries ("trade lenders"). Vehicle floorplan payable - non-trade represents amounts borrowed to finance the purchase of specific new and, to a lesser extent, used vehicle inventories with non-trade lenders, as well as amounts borrowed under our secured used floorplan facilities, which are primarily collateralized by used vehicle inventories and related receivables. Changes in vehicle floorplan

payable-trade are reported as operating cash flows and changes in vehicle floorplan payable-non-trade are reported as financing cash flows in the accompanying Unaudited Condensed Consolidated Statements of Cash Flows.

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AUTONATION, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

Our inventory costs are generally reduced by manufacturer holdbacks, incentives, and floorplan assistance, while the related vehicle floorplan payables are reflective of the gross cost of the vehicle. The vehicle floorplan payables, as shown in the above table, will generally also be higher than the inventory cost due to the timing of the sale of a vehicle and payment of the related liability.

Floorplan facilities are due on demand, but in the case of new vehicle inventories, are generally paid within several business days after the related vehicles are sold. Our manufacturer agreements generally require that the manufacturer have the ability to draft against new vehicle floorplan facilities so the lender directly funds the manufacturer for the purchase of new vehicle inventory. Floorplan facilities are primarily collateralized by vehicle inventories and related receivables.

Our floorplan facilities utilize LIBOR-based interest rates, which averaged 2.1% for the nine months ended September 30, 2012, and 2.4% for the nine months ended September 30, 2011. At September 30, 2012, the aggregate capacity under our used vehicle floorplan facilities with various lenders to finance a portion of our used vehicle inventory was \$310.0 million, of which \$111.8 million had been borrowed. The remaining borrowing capacity of \$198.2 million was limited to \$93.0 million based on the eligible used vehicle inventory that could have been pledged as collateral. At September 30, 2012, the aggregate capacity under all of our floorplan facilities to finance vehicles was approximately \$3.0 billion, of which \$2.2 billion had been borrowed.

4. GOODWILL AND INTANGIBLE ASSETS

Goodwill and intangible assets, net, consist of the following:

	September 30, 2012	December 31, 2011
Goodwill	\$1,172.2	\$1,172.2
Franchise rights - indefinite-lived	\$208.9	\$212.6
Other intangibles	8.9	8.4
	217.8	221.0
Less: accumulated amortization	(4.1	) (3.2
Other intangible assets, net	\$213.7	\$217.8

Goodwill

We test goodwill of our Domestic, Import, and Premium Luxury reporting units for impairment annually on April 30 or more frequently when events or changes in circumstances indicate that the carrying value of a reporting unit more likely than not exceeds its fair value.

Under accounting standards, we chose to make a qualitative evaluation about the likelihood of goodwill impairment to determine whether it is necessary to calculate the fair value of a reporting unit under the two-step goodwill impairment test. We completed our qualitative assessment of any potential goodwill impairment as of April 30, 2012. Based on our qualitative assessment, we determined that it was not more likely than not that the fair values of our reporting units were less than their carrying amounts and we were therefore not required to perform the two-step goodwill impairment test for any of our reporting units.

Intangible Assets

Our principal identifiable intangible assets are individual store rights under franchise agreements with vehicle manufacturers, which have indefinite lives and are tested at least annually as of April 30 for impairment. We completed our annual impairment test for our franchise rights as of April 30, 2012, and we recorded \$4.2 million (\$2.6 million after-tax) of non-cash impairment charges related to rights under a Premium Luxury store's franchise agreement. This non-cash impairment charge was recorded to reduce the carrying value of the store's franchise agreement to its estimated fair value.

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AUTONATION, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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5. LONG-TERM DEBT

Long-term debt consisted of the following:

	September 30, 2012	December 31, 2011
7% Senior Notes due 2014	\$—	\$14.7
6.75% Senior Notes due 2018	395.5	395.0
5.5% Senior Notes due 2020	350.0	—
Term loan facility due 2016	500.0	500.0
Revolving credit facility due 2016	395.0	495.0
Mortgage facility ⁽¹⁾	205.4	211.5
Capital leases	46.4	30.8
	1,892.3	1,647.0
Less: current maturities	(28.2	) (12.6
Long-term debt, net of current maturities	\$1,864.1	\$1,634.4

⁽¹⁾ The mortgage facility requires monthly principal and interest payments of \$1.7 million based on a fixed amortization schedule with a balloon payment of \$155.4 million due November 2017.

Senior Unsecured Notes and Credit Agreement

On February 1, 2012, we issued \$350.0 million aggregate principal amount of 5.5% Senior Notes due 2020. Interest is payable on February 1 and August 1 of each year. At any time prior to February 1, 2015, we may redeem up to 35% of the principal amount of these notes with the net cash proceeds of one or more public equity offerings of our common stock at 105.5% of principal. These notes will mature on February 1, 2020.

On April 16, 2012, we redeemed all of our outstanding 7% Senior Notes due 2014 at 100% of principal, for which we paid \$15.2 million (which included accrued and unpaid interest).

At September 30, 2012, we had outstanding \$395.5 million of 6.75% Senior Notes due 2018, net of debt discount. Interest on the 6.75% Senior Notes due 2018 is payable on April 15 and October 15 of each year. At any time prior to April 15, 2013, we may redeem up to 35% of the principal amount of these notes with the net cash proceeds of one or more public equity offerings of our common stock at 106.75% of principal. These notes will mature on April 15, 2018.

Under our credit agreement, we have a \$500.0 million term loan facility and a \$1.2 billion revolving credit facility. The term loan and revolving credit facilities under the credit agreement mature December 7, 2016. As of September 30, 2012, we had borrowings outstanding of \$395.0 million under our revolving credit facility. We have a \$200.0 million letter of credit sublimit as part of our revolving credit facility. The amount available to be borrowed under the revolving credit facility is reduced on a dollar-for-dollar basis by the cumulative amount of any outstanding letters of credit, which was \$56.5 million at September 30, 2012, leaving an additional borrowing capacity under the revolving credit facility of \$748.5 million at September 30, 2012. This borrowing capacity was limited under the maximum consolidated leverage ratio contained in our credit agreement to \$694.9 million as of September 30, 2012. Our term loan facility provides for various interest rates generally at LIBOR plus 1.75%. Our revolving credit facility provides for a commitment fee on undrawn amounts of 0.30% and various interest rates on borrowings generally at LIBOR plus 1.75%.

The credit spread charged for both our term loan facility and revolving credit facility is affected by our leverage ratio. For instance, an increase in our leverage ratio from greater than or equal to 2.0x but less than 3.25x to greater than or equal to 3.25x would result in a 25 basis point increase in the credit spread under both our term loan facility and revolving credit facility.

Our senior unsecured notes and borrowings under our credit agreement are guaranteed by substantially all of our subsidiaries. Within the meaning of Regulation S-X, Rule 3-10, AutoNation, Inc. (the parent company) has no independent assets or operations, the guarantees of its subsidiaries are full and unconditional and joint and several, and

any subsidiaries other than the guarantor subsidiaries are minor.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Continued)

Other Debt

At September 30, 2012, we had \$205.4 million outstanding under a mortgage facility with an automotive manufacturer's captive finance subsidiary that matures on November 30, 2017. The mortgage facility utilizes a fixed interest rate of 5.864% and is secured by 10-year mortgages on certain of our store properties. At September 30, 2012, we had capital lease obligations of \$46.4 million, which are due at various dates through 2032.

Restrictions and Covenants

Our credit agreement, the indentures for our 6.75% Senior Notes due 2018 and 5.5% Senior Notes due 2020, our vehicle floorplan facilities, and our mortgage facility contain customary financial and operating covenants that place restrictions on us, including our ability to incur additional indebtedness or prepay existing indebtedness, to create liens or other encumbrances, to sell (or otherwise dispose of) assets, and to merge or consolidate with other entities. Under our credit agreement, we are required to remain in compliance with a maximum leverage ratio and maximum capitalization ratio. The leverage ratio is a contractually defined amount principally reflecting non-vehicle debt divided by a contractually defined measure of earnings with certain adjustments. The capitalization ratio is a contractually defined amount principally reflecting vehicle floorplan payable and non-vehicle debt divided by our total capitalization including vehicle floorplan payable. Under the credit agreement, the maximum capitalization ratio is 65.0% and the maximum leverage ratio is 3.75x. In calculating our leverage and capitalization ratios, we are not required to include letters of credit in the definition of debt (except to the extent of letters of credit in excess of \$150.0 million). In addition, in calculating our capitalization ratio, we are permitted to add back to shareholders' equity all goodwill, franchise rights, and long-lived asset impairment charges subsequent to September 30, 2011 plus \$1.52 billion.

The indentures for our 6.75% Senior Notes due 2018 and 5.5% Senior Notes due 2020 contain certain limited covenants, including limitations on liens and sale and leaseback transactions. Our mortgage facility contains covenants regarding maximum cash flow leverage and minimum interest coverage.

Our failure to comply with the covenants contained in our debt agreements could permit acceleration of all of our indebtedness. Our debt agreements have cross-default provisions that trigger a default in the event of an uncured default under other material indebtedness of AutoNation.

Under the terms of our credit agreement, at September 30, 2012, our leverage ratio and capitalization ratio were as follows:

	September 30, 2012	
	Requirement	Actual
Leverage ratio	< 3.75x	2.74x
Capitalization ratio	< 65.0%	56.4%

Both the leverage ratio and the capitalization ratio limit our ability to incur additional non-vehicle debt. The capitalization ratio also limits our ability to incur additional vehicle floorplan indebtedness.

In the event of a downgrade in our credit ratings, none of the covenants described above would be impacted. In addition, availability under our credit agreement described above would not be impacted should a downgrade in our senior unsecured debt credit ratings occur.

6. INCOME TAXES

Income taxes payable included in Other Current Liabilities totaled \$0.7 million at September 30, 2012. Income taxes refundable included in Receivables, Net totaled \$10.2 million at December 31, 2011.

We file income tax returns in the U.S. federal jurisdiction and various states. As a matter of course, various taxing authorities, including the IRS, regularly audit us. Currently, no tax years are under examination by the IRS, and tax years from 2007 to 2010 are under examination by certain U.S. state jurisdictions. These audits may result in proposed assessments where the ultimate resolution may result in our owing additional taxes. We believe that our tax positions

comply with applicable tax law and that we have adequately provided for these matters.

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It is our continuing policy to account for interest and penalties associated with income tax obligations as a component of Income Tax Provision in the accompanying Unaudited Condensed Consolidated Financial Statements.

7. SHAREHOLDERS' EQUITY

A summary of shares repurchased under our stock repurchase program authorized by our Board of Directors follows:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Shares repurchased	—	5.7	15.4	10.8
Aggregate purchase price	\$—	\$195.9	\$531.6	\$365.6
Average purchase price per share	\$—	\$34.66	\$34.54	\$33.85

In July 2012, our Board of Directors authorized the repurchase of an additional \$250.0 million of shares of our common stock. As of September 30, 2012, \$368.2 million remained available under our stock repurchase authorization limit.

A summary of shares of common stock issued in connection with the exercise of stock options follows:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Shares issued	1.1	1.4	1.2	3.8
Proceeds from the exercise of stock options	\$20.3	\$26.3	\$22.1	\$66.3
Average exercise price per share	\$18.56	\$18.35	\$18.46	\$17.54

The following table presents a summary of shares of common stock issued in connection with grants of restricted stock and shares surrendered to AutoNation to satisfy tax withholding obligations in connection with the vesting of restricted stock or to pay for an option exercise (in actual number of shares):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Shares issued	5,000	—	160,740	163,892
Shares surrendered to AutoNation to satisfy tax withholding obligations in connection with the vesting of restricted stock or to pay for an option exercise	43,459	11,688	80,394	42,985

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8. EARNINGS PER SHARE

Basic earnings per share is computed by dividing net income by the weighted average number of common shares outstanding during the period, including outstanding unvested restricted stock awards which contain rights to non-forfeitable dividends. Diluted earnings per share is computed by dividing net income by the weighted average number of common shares outstanding adjusted for the dilutive effect of stock options.

The computation of weighted average common and common equivalent shares used in the calculation of basic and diluted earnings per share is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Weighted average common shares outstanding used in calculating basic earnings per share	121.2	144.4	124.4	146.9
Effect of dilutive stock options	2.2	2.6	2.0	2.6
Weighted average common and common equivalent shares used in calculating diluted earnings per share	123.4	147.0	126.4	149.5

A summary of anti-dilutive options excluded from the computation of diluted earnings per share is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Anti-dilutive options excluded from the computation of diluted earnings per share	0.9	0.4	0.9	0.4

9. ACQUISITIONS

We did not purchase any automotive retail franchises during the nine months ended September 30, 2012. We purchased one automotive retail franchise and related assets during the nine months ended September 30, 2011, for which we paid in cash \$64.2 million.

10. COMMITMENTS AND CONTINGENCIES

Legal Proceedings

We are involved, and will continue to be involved, in numerous legal proceedings arising out of the conduct of our business, including litigation with customers, employment-related lawsuits, class actions, purported class actions, and actions brought by governmental authorities. We do not believe that the ultimate resolution of these matters will have a material adverse effect on our results of operations, financial condition, or cash flows. However, the results of these matters cannot be predicted with certainty, and an unfavorable resolution of one or more of these matters could have a material adverse effect on our financial condition, results of operations, and cash flows.

Other Matters

AutoNation, acting through its subsidiaries, is the lessee under many real estate leases that provide for the use by our subsidiaries of their respective store premises. Pursuant to these leases, our subsidiaries generally agree to indemnify the lessor and other related parties from certain liabilities arising as a result of the use of the leased premises, including environmental liabilities, or a breach of the lease by the lessee. Additionally, from time to time, we enter into agreements with third parties in connection with the sale of assets or businesses in which we agree to indemnify the purchaser or related parties from certain liabilities or costs arising in connection with the assets or business. Also, in the ordinary course of business in connection with purchases or sales of goods and services, we enter into agreements that may contain indemnification provisions. In the event that an indemnification claim is asserted, our liability would be limited by the terms of the applicable agreement.

From time to time, primarily in connection with dispositions of automotive stores, our subsidiaries assign or sublet to the store purchaser the subsidiaries' interests in any real property leases associated with such stores. In general, our subsidiaries retain responsibility for the performance of certain obligations under such leases to the extent that the assignee or sublessee does not perform, whether such performance is required prior to or following the assignment or subletting of the lease.

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Additionally, AutoNation and its subsidiaries generally remain subject to the terms of any guarantees made by us and our subsidiaries in connection with such leases. Although we generally have indemnification rights against the assignee or sublessee in the event of non-performance under these leases, as well as certain defenses, we estimate that lessee rental payment obligations during the remaining terms of these leases with expirations ranging from 2012 to 2034 are approximately \$57 million at September 30, 2012. We do not have any material known commitments that we or our subsidiaries will be called on to perform under any such assigned leases or subleases at September 30, 2012. Our exposure under these leases is difficult to estimate and there can be no assurance that any performance of AutoNation or its subsidiaries required under these leases would not have a material adverse effect on our business, financial condition, and cash flows.

At September 30, 2012, surety bonds, letters of credit, and cash deposits totaled \$91.5 million, including \$56.5 million of letters of credit. In the ordinary course of business, we are required to post performance and surety bonds, letters of credit, and/or cash deposits as financial guarantees of our performance. We do not currently provide cash collateral for outstanding letters of credit.

In the ordinary course of business, we are subject to numerous laws and regulations, including automotive, environmental, health and safety, and other laws and regulations. We do not anticipate that the costs of such compliance will have a material adverse effect on our business, consolidated results of operations, cash flows, or financial condition, although such outcome is possible given the nature of our operations and the extensive legal and regulatory framework applicable to our business. The Dodd-Frank Wall Street Reform and Consumer Protection Act, which was signed into law on July 21, 2010, established a new consumer financial protection agency with broad regulatory powers. Although automotive dealers are generally excluded, the Dodd-Frank Act could lead to additional, indirect regulation of automotive dealers through its regulation of automotive finance companies and other financial institutions. In addition, we expect that the Patient Protection and Affordable Care Act, which was signed into law on March 23, 2010, will increase our annual employee health care costs that we fund, with the most significant increases commencing in 2014. Further, we expect that new laws and regulations, particularly at the federal level, in other areas may be enacted, which could also materially adversely impact our business. We do not have any material known environmental commitments or contingencies.

11. DISCONTINUED OPERATIONS

Discontinued operations are related to stores that were sold or terminated, that we have entered into an agreement to sell or terminate, or for which we otherwise deem a proposed sales transaction or termination to be probable, with no material changes expected. Generally, the sale of a store is completed within 60 to 90 days after the date of a sale agreement. We account for a store that either has been disposed of or is classified as held for sale as a discontinued operation if (a) the operations and cash flows of the store have been (or will be) eliminated from our ongoing operations and (b) we will not have any significant continuing involvement in the operations of the store after the disposal transaction.

In evaluating whether a store's cash flows will be eliminated from our ongoing operations, we consider whether we expect to continue to generate revenues or incur expenses from the sale of similar products or services to customers of the disposed store in the same geographic market. If we believe that a significant portion of the cash flows previously generated by the disposed store will migrate to our other operating stores, we will not treat the disposition as a discontinued operation.

We received no proceeds for assets held for sale in discontinued operations during the nine months ended September 30, 2012. We received \$4.9 million in proceeds (net of cash relinquished) during the same period in 2011 related to discontinued operations.

We had assets held for sale in discontinued operations of \$51.6 million at September 30, 2012, and \$51.7 million at December 31, 2011, primarily related to real estate we have not yet sold associated with stores that have been closed. Assets and liabilities of discontinued operations are reported in the "Corporate and other" category of our segment

information.

12. SEGMENT INFORMATION

At September 30, 2012 and 2011, we had three operating and reportable segments: (1) Domestic, (2) Import, and (3) Premium Luxury. As of March 31, 2012, we revised the basis of segmentation for our Import and Premium Luxury segments to reclassify Audi franchises from the Import segment to the Premium Luxury segment. In connection with this change, we have reclassified historical amounts to conform to our current segment presentation. We have five Audi franchises for which we reclassified revenue of \$49.5 million and segment income of \$3.9 million for the three months ended September 30, 2011, and revenue of \$136.9 million and segment income of \$9.5 million for the nine months ended September 30, 2011.

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Our Domestic segment is comprised of retail automotive franchises that sell new vehicles manufactured by Ford, General Motors, and Chrysler. Our Import segment is comprised of retail automotive franchises that sell new vehicles manufactured primarily by Toyota, Honda, and Nissan. Our Premium Luxury segment is comprised of retail automotive franchises that sell new vehicles manufactured primarily by Mercedes-Benz, BMW, and Lexus. The franchises in each segment also sell used vehicles, parts and automotive repair and maintenance services, and automotive finance and insurance products.

“Corporate and other” is comprised of our other businesses, including collision centers, a customer lead generation business, and an auction operation, each of which generates revenues, as well as unallocated corporate overhead expenses and retrospective commissions for certain financing and insurance transactions that we arrange under agreements with third parties.

The operating segments identified above are the business activities of the Company for which discrete financial information is available and for which operating results are regularly reviewed by our chief operating decision maker to allocate resources and assess performance. Our chief operating decision maker is our Chief Executive Officer. We have determined that our three operating segments also represent our reportable segments.

Reportable segment revenue and segment income are as follows: