

CARMAX INC  
Form 10-Q  
July 09, 2013

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 May 31, 2013

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.)

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12800 TUCKAHOE CREEK PARKWAY, RICHMOND, VIRGINIA 23238  
(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       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 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 definition of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

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

Yes       No

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

Class Outstanding as of June 30, 2013

Common Stock, par value \$0.50 223,568,579

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

Page 1

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## CARMAX, INC. AND SUBSIDIARIES

## TABLE OF CONTENTS

|          |                               | Page |
|----------|-------------------------------|------|
|          |                               | No.  |
| PART I.  | FINANCIAL INFORMATION         |      |
|          | Item 1.                       |      |
|          | Financial Statements:         |      |
|          | Consolidated Statements of    |      |
|          | Earnings –                    |      |
|          | Three Months Ended May        | 3    |
|          | 31, 2013 and 2012             |      |
|          | Consolidated Statements of    |      |
|          | Comprehensive Income –        |      |
|          | Three Months Ended May        | 4    |
|          | 31, 2013 and 2012             |      |
|          | Consolidated Balance Sheets – |      |
|          | May 31, 2013, and February    | 5    |
|          | 28, 2013                      |      |
|          | Consolidated Statements of    |      |
|          | Cash Flows –                  |      |
|          | Three Months Ended May        | 6    |
|          | 31, 2013 and 2012             |      |
|          | Notes to Consolidated         | 7    |
|          | Financial Statements          |      |
|          | Item 2.                       |      |
|          | Management's Discussion       |      |
|          | and Analysis of Financial     |      |
|          | Condition and                 | 23   |
|          | Results of Operations         |      |
|          | Item 3.                       |      |
|          | Quantitative and Qualitative  | 35   |
|          | Disclosures About Market      |      |
|          | Risk                          |      |
|          | Item 4.                       |      |
|          | Controls and Procedures       | 35   |
| PART II. | OTHER INFORMATION             |      |
|          | Item 1.                       |      |
|          | Legal Proceedings             | 36   |
|          | Item 1A.                      |      |
|          | Risk Factors                  | 37   |

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|               |   |    |
|---------------|---|----|
| Item 2.       | Unregistered Sales of Equity<br>Securities and Use of<br>Proceeds | 37 |
| Item 4.       | Mine Safety Disclosures   | 37 |
| Item 6.       | Exhibits  | 38 |
| SIGNATURES    |   | 39 |
| EXHIBIT INDEX |   | 40 |

## 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 May 31 |                  |                   |                  |
|--|---------------------------|------------------|-------------------|------------------|
|  | 2013                      | % <sup>(1)</sup> | 2012              | % <sup>(1)</sup> |
| <b>SALES AND OPERATING REVENUES:</b>         |                           |                  |                   |                  |
| Used vehicle sales                           | \$ 2,701,755              | 81.6             | \$ 2,188,907      | 78.9             |
| New vehicle sales                            | 52,427                    | 1.6              | 55,457            | 2.0              |
| Wholesale vehicle sales                      | 490,659                   | 14.8             | 467,795           | 16.9             |
| Other sales and revenues                     | 66,216                    | 2.0              | 62,261            | 2.2              |
| <b>NET SALES AND OPERATING REVENUES</b>      | <b>3,311,057</b>          | <b>100.0</b>     | <b>2,774,420</b>  | <b>100.0</b>     |
| Cost of sales                                | 2,862,961                 | 86.5             | 2,392,505         | 86.2             |
| <b>GROSS PROFIT</b>                          | <b>448,096</b>            | <b>13.5</b>      | <b>381,915</b>    | <b>13.8</b>      |
| <b>CARMAX AUTO FINANCE INCOME</b>            | <b>87,019</b>             | <b>2.6</b>       | <b>75,179</b>     | <b>2.7</b>       |
| Selling, general and administrative expenses | 290,189                   | 8.8              | 253,603           | 9.1              |
| Interest expense                             | 7,878                     | 0.2              | 8,143             | 0.3              |
| Other income                                 | 241                       |                  | 285               |                  |
| Earnings before income taxes                 | 237,289                   | 7.2              | 195,633           | 7.1              |
| Income tax provision                         | 90,638                    | 2.7              | 74,887            | 2.7              |
| <b>NET EARNINGS</b>                          | <b>\$ 146,651</b>         | <b>4.4</b>       | <b>\$ 120,746</b> | <b>4.4</b>       |
| <b>WEIGHTED AVERAGE COMMON SHARES:</b>       |                           |                  |                   |                  |
| Basic  | 224,618                   |                  | 227,773           |                  |
| Diluted                                      | 228,552                   |                  | 231,802           |                  |
| <b>NET EARNINGS PER SHARE:</b>               |                           |                  |                   |                  |
| Basic  | \$ 0.65                   |                  | \$ 0.53           |                  |

|         |         |         |
|---------|---------|---------|
| Diluted | \$ 0.64 | \$ 0.52 |
|---------|---------|---------|

(1) 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 |            |
|---|--------------------|------------|
|   | May 31             |            |
|   | 2013               | 2012       |
| NET EARNINGS                              | \$ 146,651         | \$ 120,746 |
| Other comprehensive income, net of taxes: |                    |            |
| Net change in retirement benefit plan     |                    |            |
| unrecognized actuarial losses             | 256                | 260        |
| Net change in cash flow hedge             |                    |            |
| unrecognized losses                       | 2,042              | 1,404      |
| Other comprehensive income, net of taxes  | 2,298              | 1,664      |
| TOTAL COMPREHENSIVE INCOME                | \$ 148,949         | \$ 122,410 |

See accompanying notes to consolidated financial statements.



## CARMAX, INC. AND SUBSIDIARIES

## Consolidated Balance Sheets

| (In thousands except share data)                                 | (Unaudited)          |                              |
|--|----------------------|------------------------------|
|  | As of May 31<br>2013 | As of<br>February 28<br>2013 |
| <b>ASSETS</b>  |                      |                              |
| <b>CURRENT ASSETS:</b>   |                      |                              |
| Cash and cash equivalents  | \$ 725,267           | \$ 449,364                   |
| Restricted cash from collections on auto loan receivables        | 240,715              | 224,287                      |
| Accounts receivable, net   | 70,452               | 91,961                       |
| Inventory  | 1,398,200            | 1,517,813                    |
| Deferred income taxes  | 4,737                | 5,193                        |
| Other current assets   | 15,402               | 21,513                       |
| <b>TOTAL CURRENT ASSETS</b>                                      | <b>2,454,773</b>     | <b>2,310,131</b>             |
| Auto loan receivables, net                                       | 6,310,446            | 5,895,918                    |
| Property and equipment, net                                      | 1,444,128            | 1,428,970                    |
| Deferred income taxes  | 138,158              | 145,875                      |
| Other assets   | 102,949              | 107,708                      |
| <b>TOTAL ASSETS</b>  | <b>\$ 10,450,454</b> | <b>\$ 9,888,602</b>          |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                      |                      |                              |
| <b>CURRENT LIABILITIES:</b>                                      |                      |                              |
| Accounts payable   | \$ 316,640           | \$ 336,721                   |
| Accrued expenses and other current liabilities                   | 109,714              | 147,821                      |
| Accrued income taxes   | 58,965               | 222                          |
| Short-term debt  | 972                  | 355                          |
| Current portion of finance and capital lease obligations         | 16,830               | 16,139                       |
| Current portion of non-recourse notes payable                    | 207,113              | 182,915                      |
| <b>TOTAL CURRENT LIABILITIES</b>                                 | <b>710,234</b>       | <b>684,173</b>               |
| Finance and capital lease obligations, excluding current portion | 332,965              | 337,452                      |
| Non-recourse notes payable, excluding current portion            | 6,160,242            | 5,672,175                    |
| Other liabilities  | 171,631              | 175,635                      |
| <b>TOTAL LIABILITIES</b>   | <b>7,375,072</b>     | <b>6,869,435</b>             |
| Commitments and contingent liabilities                           |                      |                              |
| <b>SHAREHOLDERS' EQUITY:</b>                                     |                      |                              |
| Common stock, \$0.50 par value; 350,000,000 shares authorized;   |                      |                              |

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|   |               |              |
|---|---------------|--------------|
| 224,145,439 and 225,906,108 shares issued and outstanding<br>as of May 31, 2013 and February 28, 2013, respectively | 112,073       | 112,953      |
| Capital in excess of par value  | 990,778       | 972,250      |
| Accumulated other comprehensive loss  | (57,510)      | (59,808)     |
| Retained earnings   | 2,030,041     | 1,993,772    |
| TOTAL SHAREHOLDERS' EQUITY  | 3,075,382     | 3,019,167    |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY  | \$ 10,450,454 | \$ 9,888,602 |

See accompanying notes to consolidated financial statements.

## CARMAX, INC. AND SUBSIDIARIES

## Consolidated Statements of Cash Flows

(Unaudited)

| (In thousands)  | Three Months Ended May 31 |                  |
|---|---------------------------|------------------|
|   | 2013                      | 2012             |
| <b>OPERATING ACTIVITIES:</b>  |                           |                  |
| Net earnings  | \$ 146,651                | \$ 120,746       |
| Adjustments to reconcile net earnings to net cash used in operating activities:           |                           |                  |
| Depreciation and amortization   | 24,335                    | 22,982           |
| Share-based compensation expense  | 22,941                    | 15,592           |
| Provision for loan losses   | 11,299                    | 9,176            |
| (Gain) loss on disposition of assets  | (178)                     | 192              |
| Deferred income tax provision   | 6,695                     | 7,511            |
| Net decrease (increase) in:   |                           |                  |
| Accounts receivable, net  | 21,509                    | 20,729           |
| Inventory   | 119,613                   | (117,604)        |
| Other current assets  | 7,293                     | 7,242            |
| Auto loan receivables, net  | (425,827)                 | (181,492)        |
| Other assets  | (2,592)                   | 2,225            |
| Net increase (decrease) in:   |                           |                  |
| Accounts payable, accrued expenses and other current liabilities and accrued income taxes | 533                       | (7,641)          |
| Other liabilities   | (9,851)                   | (15,178)         |
| <b>NET CASH USED IN OPERATING ACTIVITIES</b>  | <b>(77,579)</b>           | <b>(115,520)</b> |
| <b>INVESTING ACTIVITIES:</b>  |                           |                  |
| Capital expenditures  | (42,045)                  | (47,636)         |
| Proceeds from sales of assets   | 4,610                     |                  |
| (Increase) decrease in restricted cash from collections on auto loan receivables          | (16,428)                  | 21,998           |
| Increase in restricted cash in reserve accounts   | (2,812)                   | (236)            |
| Release of restricted cash from reserve accounts  | 10,011                    | 6,382            |
| Sales of money market securities, net   | 1,313                     | 169              |
| Purchases of investments available-for-sale   | (1,161)                   | (1,096)          |
| <b>NET CASH USED IN INVESTING ACTIVITIES</b>  | <b>(46,512)</b>           | <b>(20,419)</b>  |
| <b>FINANCING ACTIVITIES:</b>  |                           |                  |
| Increase (decrease) in short-term debt, net   | 617                       | (152)            |
| Payments on finance and capital lease obligations   | (3,796)                   | (3,296)          |
| Issuances of non-recourse notes payable   | 1,774,000                 | 698,000          |
| Payments on non-recourse notes payable  | (1,261,735)               | (556,900)        |

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|   |            |            |
|---|------------|------------|
| Repurchase and retirement of common stock                 | (130,215)  |            |
| Equity issuances, net                                     | 11,204     | 2,529      |
| Excess tax benefits from share-based payment arrangements | 9,919      | 9,513      |
| NET CASH PROVIDED BY FINANCING ACTIVITIES                 | 399,994    | 149,694    |
| Increase in cash and cash equivalents                     | 275,903    | 13,755     |
| Cash and cash equivalents at beginning of year            | 449,364    | 442,658    |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD                | \$ 725,267 | \$ 456,413 |

See accompanying notes to consolidated financial statements.

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 operate in two reportable segments: CarMax Sales Operations and CarMax Auto Finance (“CAF”). Our CarMax Sales Operations segment consists of all aspects of our auto merchandising and service operations, excluding financing provided by CAF. Our CAF segment consists solely of our own finance operation that provides vehicle financing through CarMax superstores.

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, 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 28, 2013.

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. Amounts and percentages may not total due to rounding.

Cash and Cash Equivalents. Cash equivalents of \$706.9 million as of May 31, 2013, and \$430.3 million as of February 28, 2013, consisted of highly liquid investments with original maturities of three months or less.

Restricted Cash from Collections on Auto Loan Receivables. Cash accounts totaling \$240.7 million as of May 31, 2013, and \$224.3 million as of February 28, 2013, 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. These entities 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 trusts. 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 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 related to retail vehicle sales financed through CAF. The receivables 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, and thus, are

expensed as incurred. 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 totaled \$34.1 million as of May 31, 2013, and \$41.3 million as of February 28, 2013.

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 \$34.8 million as of May 31, 2013, and \$35.0 million as of February 28, 2013.

**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, and 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.

**Effective in the Current Period.** In December 2011, the Financial Accounting Standards Board (“FASB”) issued an accounting pronouncement related to the 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. In January 2013, an update was issued to clarify that the scope applies to derivatives. The provisions of this pronouncement are effective for fiscal years, and interim periods within those years, beginning after January 1, 2013. We adopted this pronouncement for our fiscal year beginning March 1, 2013. This pronouncement did not 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 of this pronouncement are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. We adopted this pronouncement for our fiscal year beginning March 1, 2013. This pronouncement did not have a material effect on our consolidated financial statements.

In February 2013, the FASB issued an accounting pronouncement related to comprehensive income (FASB ASC Topic 220), requiring improved disclosures of reclassifications out of accumulated other comprehensive income. The provisions of the pronouncement require an entity to report the amounts reclassified, in their entirety, out of accumulated other comprehensive income and the effect on the respective line items in net income. For amounts not reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference the amounts to other related disclosures. This pronouncement is effective for fiscal years, and interim periods within those years, beginning after December 15, 2012. We adopted this pronouncement for our fiscal year beginning March 1, 2013. We have included the additional required disclosures for our first quarter ended May 31, 2013.

**Effective in Future Periods.** In February 2013, the FASB issued an accounting pronouncement related to liabilities (FASB ASC Topic 405). The amendments provide guidance on the recognition, measurement and disclosure of obligations resulting from joint and several liability arrangements, including debt arrangements, other contractual obligations, and settled litigation and judicial rulings. This pronouncement is effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. We will adopt this pronouncement for our fiscal year beginning March 1, 2014. We do not expect this pronouncement to have a material effect on our consolidated financial statements.

### 3. CarMax Auto Finance Income

CAF provides financing to qualified customers purchasing vehicles at CarMax. CAF provides us the opportunity to capture additional sales, profits and cash flows while managing our reliance on third-party finance sources. Management regularly analyzes CAF's operating results by assessing profitability, the performance of the auto loan receivables including trends in credit losses and delinquencies, and CAF direct expenses. This information is used to assess CAF's performance and make operating decisions including resource allocation. In addition, except for auto loan receivables, which are disclosed in Note 4, CAF assets are not separately reported nor do we allocate assets to CAF because such allocation would not be useful to management in making operating decisions.

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. 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.

| (In millions)   | Three Months Ended May 31 |          |            |       |
|---|---------------------------|----------|------------|-------|
|   | 2013                      | %<br>(1) | 2012       | % (1) |
| Interest margin:                                      |                           |          |            |       |
| Interest and fee income                               | \$ 133.5                  | 8.7      | \$ 120.3   | 9.5   |
| Interest expense                                      | (22.8)                    | (1.5)    | (25.1)     | (2.0) |
| Total interest margin                                 | 110.7                     | 7.2      | 95.2       | 7.5   |
| Provision for loan losses                             | (11.3)                    | (0.7)    | (9.2)      | (0.7) |
| Total interest margin after provision for loan losses | 99.4                      | 6.5      | 86.0       | 6.8   |
| Direct expenses:                                      |                           |          |            |       |
| Payroll and fringe benefit expense                    | (5.5)                     | (0.4)    | (5.3)      | (0.4) |
| Other direct expenses                                 | (6.9)                     | (0.4)    | (5.5)      | (0.4) |
| Total direct expenses                                 | (12.4)                    | (0.8)    | (10.8)     | (0.9) |
| CarMax Auto Finance income                            | \$ 87.0                   | 5.7      | \$ 75.2    | 5.9   |
| Total average managed receivables                     | \$ 6,152.5                |          | \$ 5,075.2 |       |

(1) Annualized percent of total average managed receivables.

#### 4. Auto Loan Receivables

Auto loan receivables include amounts due from customers related to 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 the auto loan receivables serve as collateral for the related non-recourse notes payable of \$6.37 billion as of May 31, 2013, and \$5.86 billion as of February 28, 2013. See Notes 2 and 9 for additional information on securitizations and non-recourse notes payable.

#### Auto Loan Receivables, Net

| (In millions)                    | As of May<br>31<br>2013 | As of<br>February 28<br>2013 |
|----------------------------------|-------------------------|------------------------------|
| Warehouse facilities             | \$ 941.0                | \$ 792.0                     |
| Term securitizations             | 5,219.2                 | 4,989.7                      |
| Other receivables (1)            | 174.5                   | 151.6                        |
| Total ending managed receivables | 6,334.7                 | 5,933.3                      |
| Accrued interest and fees        | 27.8                    | 24.9                         |

|                                |            |            |
|--------------------------------|------------|------------|
| Other                          | 8.8        | (5.0)      |
| Less allowance for loan losses | (60.9)     | (57.3)     |
| Auto loan receivables, net     | \$ 6,310.4 | \$ 5,895.9 |

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

**Credit Quality.** When customers apply for financing, CAF's proprietary scoring models 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. The 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 May 31        |                  | As of February 28   |                  |
|----------------------------------|---------------------|------------------|---------------------|------------------|
|                                  | 2013 <sup>(1)</sup> | % <sup>(2)</sup> | 2013 <sup>(1)</sup> | % <sup>(2)</sup> |
| A                                | \$ 3,055.3          | 48.2             | \$ 2,841.4          | 47.9             |
| B                                | 2,387.0             | 37.7             | 2,265.6             | 38.2             |
| C and other                      | 892.4               | 14.1             | 826.3               | 13.9             |
| Total ending managed receivables | \$ 6,334.7          | 100.0            | \$ 5,933.3          | 100.0            |

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

<sup>(2)</sup> Percent of total ending managed receivables.

#### Allowance for Loan Losses

| (In millions)                     | Three Months Ended May 31 |                  |         |                  |
|-----------------------------------|---------------------------|------------------|---------|------------------|
|                                   | 2013                      | % <sup>(1)</sup> | 2012    | % <sup>(1)</sup> |
| Balance as of beginning of period | \$ 57.3                   | 1.0              | \$ 43.3 | 0.9              |
| Charge-offs                       | (26.4)                    |                  | (20.6)  |                  |
| Recoveries                        | 18.7                      |                  | 14.7    |                  |
| Provision for loan losses         | 11.3                      |                  | 9.2     |                  |
| Balance as of end of period       | \$ 60.9                   | 1.0              | \$ 46.6 | 0.9              |

<sup>(1)</sup> 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 May 31 |                  | As of February 28 |                  |
|----------------------------------|--------------|------------------|-------------------|------------------|
|                                  | 2013         | % <sup>(1)</sup> | 2013              | % <sup>(1)</sup> |
| Total ending managed receivables | \$ 6,334.7   | 100.0            | \$ 5,933.3        | 100.0            |
| Delinquent loans:                |              |                  |                   |                  |
| 31-60 days past due              | \$ 110.0     | 1.7              | \$ 109.5          | 1.8              |
| 61-90 days past due              | 32.9         | 0.5              | 32.7              | 0.6              |
| Greater than 90 days past due    | 11.5         | 0.2              | 12.0              | 0.2              |
| Total past due                   | \$ 154.4     | 2.4              | \$ 154.2          | 2.6              |

<sup>(1)</sup> 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.

**Designated Cash Flow Hedges.** Our objectives in using interest rate derivatives are to add stability to CAF's 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 that 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 \$10.4 million will be reclassified as a decrease to CAF income.

As of May 31, 2013, we had interest rate swaps outstanding with a combined notional amount of \$937.0 million that were designated as cash flow hedges of interest rate risk.

Non-designated Hedges. Derivative instruments not designated as accounting hedges are not speculative. These instruments are used to limit risk for investors in the warehouse facilities, to minimize CAF's 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 May 31, 2013, we had interest rate caps outstanding with offsetting (asset and liability) notional amounts of \$534.1 million that were not designated as accounting hedges.



## Fair Values of Derivative Instruments

| (In thousands)  | As of May 31, 2013 |             | As of February 28, 2013 |             |
|---|--------------------|-------------|-------------------------|-------------|
|   | Assets             | Liabilities | Assets                  | Liabilities |
| Derivatives designated as accounting hedges:          |                    |             |                         |             |
| Interest rate swaps <sup>(1)</sup>                    | \$ 1,236           | \$          | \$                      | \$          |
| Interest rate swaps <sup>(2)</sup>                    |                    | (157)       |                         | (517)       |
| Total derivatives designated as accounting hedges     | 1,236              | (157)       |                         | (517)       |
| Derivatives not designated as accounting hedges:      |                    |             |                         |             |
| Interest rate caps <sup>(1)</sup>                     | 18                 | (18)        | 26                      | (26)        |
| Total derivatives not designated as accounting hedges | 18                 | (18)        | 26                      | (26)        |
| Total   | \$ 1,254           | \$ (175)    | \$ 26                   | \$ (543)    |

<sup>(1)</sup> Reported in other current assets on the consolidated balance sheets.

<sup>(2)</sup> Reported in accounts payable on the consolidated balance sheets.

## Effect of Derivative Instruments on Comprehensive Income

| (In thousands)   | Three Months Ended |             |
|--|--------------------|-------------|
|  | May 31 2013        | May 31 2012 |
| Derivatives designated as accounting hedges:               |                    |             |
| Gain (loss) recognized in AOCL <sup>(1)</sup>              | \$ 462             | \$ (3,012)  |
| Loss reclassified from AOCL into CAF income <sup>(1)</sup> | \$ (2,905)         | \$ (3,235)  |
| Gain recognized in CAF Income <sup>(2)</sup>               | \$ 21              | \$          |
| Derivatives not designated as accounting hedges:           |                    |             |
| Loss recognized in CAF income <sup>(3)</sup>               | \$                 | \$ (1)      |

<sup>(1)</sup> Represents the effective portion.

<sup>(2)</sup> Represents the ineffective portion.

<sup>(3)</sup> 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 established to fund 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. Quotes from third-party valuation services and quotes received from bank counterparties 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. The models do not require significant judgment and model inputs can typically be observed in the liquid market; however, because the models include inputs other than quoted prices in active markets, all 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 May 31, 2013 |          | Total      |   |         |
|---------------------------------------|--------------------|----------|------------|---|---------|
|                                       | Level 1            | Level 2  |            |   |         |
| Assets:                               |                    |          |            |   |         |
| Money market securities               | \$ 736,504         | \$       | \$ 736,504 |   |         |
| Mutual fund investments               | 5,185              |          | 5,185      |   |         |
| Derivative instruments                |                    | 1,236    | 1,236      |   |         |
| Total assets at fair value            | \$ 741,689         | \$ 1,236 | \$ 742,925 |   |         |
| Percent of total assets at fair value | 99.8               | %        | 0.2        | % | 100.0 % |
| Percent of total assets               | 7.1                | %        |            | % | 7.1 %   |
| Liabilities:                          |                    |          |            |   |         |
| Derivative instruments                | \$                 | \$ 157   | \$ 157     |   |         |
| Total liabilities at fair value       | \$                 | \$ 157   | \$ 157     |   |         |
| Percent of total liabilities          |                    | %        |            | % | %       |

| (In thousands)                        | As of February 28, 2013 |         |            |       |   |
|---------------------------------------|-------------------------|---------|------------|-------|---|
|                                       | Level 1                 | Level 2 | Total      |       |   |
| Assets:                               |                         |         |            |       |   |
| Money market securities               | \$ 461,260              | \$      | \$ 461,260 |       |   |
| Mutual fund investments               | 4,024                   |         | 4,024      |       |   |
| Derivative instruments                |                         |         |            |       |   |
| Total assets at fair value            | \$ 465,284              | \$      | \$ 465,284 |       |   |
| Percent of total assets at fair value | 100.0                   | %       | %          | 100.0 | % |
| Percent of total assets               | 4.7                     | %       | %          | 4.7   | % |
| Liabilities:                          |                         |         |            |       |   |
| Derivative instruments                | \$                      | \$ 517  | \$ 517     |       |   |
| Total liabilities at fair value       | \$                      | \$ 517  | \$ 517     |       |   |
| Percent of total liabilities          |                         | %       | %          |       | % |

## 7. Income Taxes

We had \$26.1 million of gross unrecognized tax benefits as of May 31, 2013, and \$25.1 million as of February 28, 2013. There were no significant changes to the gross unrecognized tax benefits as reported for the year ended February 28, 2013, 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 May 31 |  | Total |
|----------------|---------------------------|--|-------|
|                | Pension Plan              |  |       |
|                |                           |  |       |

|                                |          |          | Restoration<br>Plan |        |          |          |
|--------------------------------|----------|----------|---------------------|--------|----------|----------|
|                                | 2013     | 2012     | 2013                | 2012   | 2013     | 2012     |
| Interest cost                  | \$ 1,896 | \$ 1,826 | \$ 99               | \$ 115 | \$ 1,995 | \$ 1,941 |
| Expected return on plan assets | (1,980)  | (1,883)  |                     |        | (1,980)  | (1,883)  |
| Recognized actuarial loss      | 408      | 300      |                     |        | 408      | 300      |
| Net pension expense            | \$ 324   | \$ 243   | \$ 99               | \$ 115 | \$ 423   | \$ 358   |

We made no contributions to the pension plan during the three months ended May 31, 2013. We anticipate making \$1.7 million in contributions during the remainder of fiscal 2014. The expected long-term rate of return on plan assets for the pension plan was 7.75% as of February 28, 2013.

## 9. Debt

| (In thousands)   | As of May 31<br>2013 | As of February 28<br>2013 |
|--|----------------------|---------------------------|
| Short-term revolving credit facility                             | \$ 972               | \$ 355                    |
| Current portion of finance and capital lease obligations         | 16,830               | 16,139                    |
| Current portion of non-recourse notes payable                    | 207,113              | 182,915                   |
| Total current debt   | 224,915              | 199,409                   |
| Finance and capital lease obligations, excluding current portion | 332,965              | 337,452                   |
| Non-recourse notes payable, excluding current portion            | 6,160,242            | 5,672,175                 |
| Total debt, excluding current portion                            | 6,493,207            | 6,009,627                 |
| Total debt   | \$ 6,718,122         | \$ 6,209,036              |

**Revolving Credit Facility.** Our \$700 million unsecured revolving credit facility (the “credit facility”) expires in August 2016. Borrowings under the credit facility are available for working capital and general corporate purposes. Borrowings accrue interest at variable rates based on LIBOR, the federal funds rate, or the prime rate, depending on the type of borrowing, and we pay a commitment fee on the unused portions of the available funds. As of May 31, 2013, 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 that did not qualify for sale accounting, and therefore, are accounted for as financings. The leases were structured at varying interest rates and generally have 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.

We have not entered into any sale-leaseback transactions since fiscal 2009.

**Non-Recourse Notes Payable.** The non-recourse notes payable relate to auto loan receivables funded through term securitizations and our warehouse facilities. 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. The current portion of non-recourse notes payable represents principal payments that are due to be distributed in the following period.

As of May 31, 2013, \$5.43 billion of non-recourse notes payable was outstanding related to term securitizations. These notes payable accrue interest at fixed rates and have scheduled maturities through November 2019, but may mature earlier or later, depending upon the repayment rate of the underlying auto loan receivables.

As of May 31, 2013, \$941.0 million of auto loan receivables was outstanding related to our warehouse facilities. The combined warehouse facility limit was \$1.7 billion, and unused warehouse capacity totaled \$759.0 million. Of the combined warehouse facility limit, \$800 million will expire in August 2013 and \$900 million will expire in February 2014. The notes payable outstanding related to our warehouse facilities do not have scheduled maturities, instead the principal payments depend upon the repayment rate of underlying auto loan receivables. The return requirements of the investors could fluctuate significantly depending on market conditions. Therefore, at renewal, the cost, structure and capacity of the facilities could change. These changes could have a significant impact on our funding costs.

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

**Financial Covenants.** The credit facility agreement contains representations and warranties, conditions and covenants. We must also meet financial covenants in conjunction with certain of the sale-leaseback transactions. Our securitization agreements contain representations and warranties, financial covenants and performance triggers. As of May 31, 2013, we were in compliance with all financial covenants and our securitized receivables were in compliance with the related performance triggers.

#### 10. Stock and Stock-Based Incentive Plans

##### (A) Share Repurchase Program

In October 2012, our board of directors authorized the repurchase of up to \$300 million of our common stock. In January 2013, our board of directors authorized an additional \$500 million for the repurchase of our common stock. Purchases



may be made in open market or privately negotiated transactions at management's discretion and the timing and amount of repurchases are determined based on share price, market conditions, legal requirements and other factors. Shares repurchased are deemed authorized but unissued shares of common stock.

For the three months ended May 31, 2013, we repurchased 2,945,622 shares of common stock at an average purchase price of \$42.29 per share. As of May 31 2013, \$463.5 million was available for repurchase under the authorizations, which expire on December 31, 2014.

(B) Stock Incentive Plans

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.

(C) Share-Based Compensation

Composition of Share-Based Compensation Expense

| (In thousands)  | Three Months Ended |           |
|---|--------------------|-----------|
|   | May 31             |           |
|   | 2013               | 2012      |
| Cost of sales   | \$ 1,273           | \$ 415    |
| CarMax Auto Finance income                            | 782                | 478       |
| Selling, general and administrative expenses          | 21,174             | 14,924    |
| Share-based compensation expense, before income taxes | \$ 23,229          | \$ 15,817 |

## Composition of Share-Based Compensation Expense – By Grant Type

| (In thousands)  | Three Months Ended<br>May 31 |           |
|---|------------------------------|-----------|
|   | 2013                         | 2012      |
| Nonqualified stock options                            | \$ 7,033                     | \$ 8,713  |
| Cash-settled restricted stock units                   | 12,088                       | 2,700     |
| Stock-settled restricted stock units                  | 3,820                        | 4,179     |
| Employee stock purchase plan                          | 288                          | 225       |
| Share-based compensation expense, before income taxes | \$ 23,229                    | \$ 15,817 |

We recognize compensation expense for stock options and MSUs 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 three months ended May 31, 2013 or 2012.

## Stock Option Activity

| (Shares and intrinsic value in thousands) | Number<br>of<br>Shares | Weighted<br>Average<br>Exercise<br>Price | Weighted                                 | Aggregate          |
|---|------------------------|--|--|--------------------|
|   |                        |  | Remaining<br>Contractual<br>Life (Years) | Intrinsic<br>Value |
| Outstanding as of February 28, 2013       | 10,771                 | \$ 23.00                                 |  |                    |
| Options granted                           | 1,569                  | 42.68                                    |  |                    |
| Options exercised                         | (912)                  | 18.63                                    |  |                    |
| Options forfeited or expired              | (21)                   | 30.99                                    |  |                    |
| Outstanding as of May 31, 2013            | 11,407                 | \$ 26.05                                 | 4.2                                      | \$ 236,409         |
| Exercisable as of May 31, 2013            | 7,093                  | \$ 20.48                                 | 3.1                                      | \$ 186,490         |

For the three months ended May 31, 2013 and 2012, we granted nonqualified options to purchase 1,569,117 and 2,179,757 shares of common stock, respectively. The total cash received as a result of stock option exercises for the three months ended May 31, 2013 and 2012, was \$17.0 million and \$10.9 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 three months ended May 31, 2013 and 2012, was \$23.4 million and \$10.7 million, respectively. We realized related tax benefits of \$9.4 million and \$4.1 million during the three months ended May 31, 2013 and 2012, respectively.



## Outstanding Stock Options

| Range of Exercise Prices | As of May 31, 2013  |                     |                     |                     | Options Exercisable |                     |
|--------------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
|                          | Options Outstanding | Options Outstanding | Options Outstanding | Options Outstanding | Options Exercisable | Options Exercisable |
|                          | Number              | Weighted            | Weighted            | Weighted            | Weighted            | Weighted            |
| (Shares in thousands)    | of                  | Average             | Average             | Average             | Average             | Average             |
| Range of Exercise Prices | Shares              | Remaining           | Exercise            | Remaining           | Exercise            | Exercise            |
|                          |                     | Contractual         | Price               | Contractual         | Price               | Price               |
|                          |                     | Life (Years)        |                     | Life (Years)        |                     |                     |
| \$ 11.43                 | 1,698               | 2.9                 | \$ 11.43            | 1,698               | \$ 11.43            | \$ 11.43            |
| \$ 13.19 - \$ 19.82      | 2,434               | 1.8                 | \$ 16.42            | 2,434               | \$ 16.42            | \$ 16.42            |
| \$ 19.98 - \$ 25.39      | 1,767               | 3.6                 | \$ 25.18            | 1,335               | \$ 25.19            | \$ 25.19            |
| \$ 25.67 - \$ 32.05      | 2,195               | 5.7                 | \$ 31.57            | 666                 | \$ 31.33            | \$ 31.33            |
| \$ 32.69 - \$ 42.68      | 3,313               | 5.8                 | \$ 37.41            | 960                 | \$ 32.70            | \$ 32.70            |
| Total                    | 11,407              | 4.2                 | \$ 26.05            | 7,093               | \$ 20.48            | \$ 20.48            |

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 three months ended May 31, 2013 and 2012, was \$15.55 and \$12.74, respectively. The unrecognized compensation costs related to nonvested options totaled \$48.9 million as of May 31, 2013. These costs are expected to be recognized on a straight-line basis over a weighted average period of 2.7 years.

## Assumptions Used to Estimate Option Values

|   | Three Months Ended May 31 |                 |
|---|---------------------------|-----------------|
|   | 2013                      | 2012            |
| Dividend yield                            | 0.0 %                     | 0.0 %           |
| Expected volatility factor <sup>(1)</sup> | 28.1 % - 46.8 %           | 32.4 % - 51.4 % |
| Weighted average expected volatility      | 44.8 %                    | 49.4 %          |
| Risk-free interest rate <sup>(2)</sup>    | 0.04 % - 1.7 %            | 0.01 % - 2.0 %  |
| Expected term (in years) <sup>(3)</sup>   | 4.7                       | 4.7             |

- (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

|                                     | Number      | Weighted<br>Average<br>Grant<br>Date<br>Fair Value |
|-------------------------------------|-------------|--|
| (Units in thousands)                | of<br>Units |  |
| Outstanding as of February 28, 2013 | 1,651       | \$ 29.90   |
| Stock units granted                 | 542         | \$ 42.68   |
| Stock units vested and converted    | (552)       | \$ 25.42   |
| Stock units cancelled               | (21)        | \$ 33.00   |
| Outstanding as of May 31, 2013      | 1,620       | \$ 35.67   |

For the three months ended May 31, 2013 and 2012, we granted RSUs of 541,741 units and 644,232 units, respectively. The initial weighted average fair market value per unit at the date of grant for the RSUs granted during the three months ended May 31, 2013 and 2012, was \$42.68 and \$31.76, respectively. The RSUs are cash-settled upon vesting. For the three months ended May 31, 2013 and 2012, we paid \$22.7 million and \$17.7 million, respectively (before payroll tax withholdings) to RSU holders upon the vesting of RSUs. We realized tax benefits of \$9.0 million and \$6.8 million during the three months ended May 31, 2013 and 2012, respectively.

#### Expected Cash Settlement Range Upon Restricted Stock Unit Vesting

| (In thousands)                  | As of May 31, 2013 |                        |
|---------------------------------|--------------------|------------------------|
|                                 | Minimum            | Maximum <sup>(1)</sup> |
| Fiscal 2015                     | \$ 11,408          | \$ 30,420              |
| Fiscal 2016                     | 12,524             | 33,398                 |
| Fiscal 2017                     | 14,173             | 37,793                 |
| Total expected cash settlements | \$ 38,105          | \$ 101,611             |

<sup>(1)</sup> Net of estimated forfeitures.

#### Stock-Settled Restricted Stock Unit Activity

| (Units in thousands)                | Weighted<br>Average   |                             |
|-------------------------------------|-----------------------|-----------------------------|
|                                     | Number<br>of<br>Units | Grant<br>Date<br>Fair Value |
| Outstanding as of February 28, 2013 | 904                   | \$ 40.78                    |
| Stock units granted                 | 235                   | \$ 51.95                    |
| Stock units vested and converted    | (261)                 | \$ 36.24                    |
| Stock units cancelled               | (7)                   | \$ 45.22                    |
| Outstanding as of May 31, 2013      | 871                   | \$ 45.12                    |

For the three months ended May 31, 2013 and 2012, we granted MSUs of 235,459 units and 346,551 units, respectively. The weighted average fair value per unit at the date of grant for MSUs granted during the three months ended May 31, 2013 and 2012, was \$51.95 and \$40.36, 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 \$6.8 million and \$9.5 million for the three months ended May 31, 2013 and 2012, respectively, from the vesting of market stock units. The unrecognized compensation costs related to nonvested MSUs totaled \$21.9 million as of May 31, 2013. 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.



## Basic and Dilutive Net Earnings Per Share Reconciliations

| (In thousands except per share data)                                | Three Months Ended |            |
|---|--------------------|------------|
|   | May 31             |            |
|   | 2013               | 2012       |
| Net earnings  | \$ 146,651         | \$ 120,746 |
| Weighted average common shares outstanding                          | 224,618            | 227,773    |
| Dilutive potential common shares:                                   |                    |            |
| Stock options   | 3,194              | 3,433      |
| Stock-settled restricted stock units                                | 740                | 596        |
| Weighted average common shares and dilutive potential common shares | 228,552            | 231,802    |
| Basic net earnings per share  | \$ 0.65            | \$ 0.53    |
| Diluted net earnings per share                                      | \$ 0.64            | \$ 0.52    |

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 May 31, 2013 and 2012, weighted average options to purchase 801,614 shares and 3,202,825 shares of common stock, respectively, were not included.

## 12. Accumulated Other Comprehensive Loss

## Changes in Accumulated Other Comprehensive Loss by Component

| (In thousands, net of income taxes)                            | Net<br>Unrecognized<br>Actuarial<br>Losses | Net<br>Unrecognized<br>Hedge Losses | Total<br>Accumulated<br>Other<br>Comprehensive<br>Loss |
|--|--|-------------------------------------|--|
| Balance as of February 28, 2013                                | \$ (49,479)                                | \$ (10,329)                         | \$ (59,808)  |
| Other comprehensive income before reclassifications            |  | 281                                 | 281  |
| Amounts reclassified from accumulated other comprehensive loss | 256  | 1,761                               | 2,017  |
| Other comprehensive income                                     | 256  | 2,042                               | 2,298  |
| Balance as of May 31, 2013                                     | \$ (49,223)                                | \$ (8,287)                          | \$ (57,510)  |



## Changes In and Reclassifications Out of Accumulated Other Comprehensive Loss

| (In thousands)   | Three Months<br>Ended May 31 |          |
|--|------------------------------|----------|
|  | 2013                         | 2012     |
| Retirement Benefit Plans (Note 8):   |                              |          |
| Actuarial loss amortization reclassifications recognized in net pension expense: |                              |          |
| Cost of sales  | \$ 162                       | \$ 118   |
| CarMax Auto Finance income   | 9                            | 7        |
| Selling, general and administrative expenses                                     | 237                          | 175      |
| Total amortization reclassifications recognized in net pension expense           | 408                          | 300      |
| Tax expense  | (152)                        | (40)     |
| Amortization reclassifications recognized in net pension expense, net of tax     | 256                          | 260      |
| Net change in retirement benefit plan unrecognized actuarial losses, net of tax  | 256                          | 260      |
| Cash Flow Hedges (Note 5):   |                              |          |
| Effective portion of changes in fair value                                       | 462                          | (3,012)  |
| Tax (expense) benefit  | (181)                        | 1,181    |
| Effective portion of changes in fair value, net of tax                           | 281                          | (1,831)  |
| Reclassifications to CarMax Auto Finance income                                  | 2,905                        | 3,235    |
| Tax expense <sup>(1)</sup>   | (1,144)                      | -        |
| Reclassification of hedge losses, net of tax                                     | 1,761                        | 3,235    |
| Net change in cash flow hedge unrecognized losses, net of tax                    | 2,042                        | 1,404    |
| Total other comprehensive income, net of tax                                     | \$ 2,298                     | \$ 1,664 |

<sup>(1)</sup> As disclosed in our second quarter filing on Form 10-Q for fiscal 2013, the three months and six months ended August 31, 2012, included a tax provision adjustment of \$1,270 related to the first quarter of fiscal 2013.

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 \$34.4 million as of May 31, 2013, and \$35.9 million as of February 28, 2013.

## 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 with the California Court of Appeal. On March 26, 2013, the California Court of Appeal reversed the trial court's order granting CarMax's motion to compel arbitration. CarMax is pursuing an appeal of this decision and has filed a Petition for Review with the California Supreme Court. 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.

On May 29, 2013, CarMax Auto Superstores, Inc. and CarMax Business Services, LLC (collectively, "CarMax") filed a lawsuit against eVox Productions, LLC ("eVox") in the United States District Court for the Eastern District of Virginia (the "Virginia Action") seeking a declaratory judgment that, among other things, CarMax did not infringe eVox's copyrights of certain vehicle photographs. On June 5, 2013, eVox filed a lawsuit against CarMax, Transtock, Inc., Dean Siracusa and Does 1 through 10 in the United States District Court for the Central District of California seeking a judgment that CarMax: (i) infringed eVox's copyrights of certain vehicle photographs; (ii) infringed eVox's trademarks; and (iii) engaged in false advertising and unfair competition. On June 19, 2013, eVox filed a motion to dismiss, transfer or stay the Virginia Action. eVox seeks injunctive relief, actual or statutory damages, a finding of willful infringement, an accounting, trebled damages, attorneys' fees and interest. We believe that insurance coverage will be available to CarMax for some or all of this matter. We are unable to make a reasonable estimate of the amount or range of loss that could result from an unfavorable outcome in this matter.

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 28, 2013 ("fiscal 2013"), 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. All references to net earnings per share are to diluted net earnings per share. Amounts and percentages may not total due to rounding.

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 operate in two reportable segments: CarMax Sales Operations and CarMax Auto Finance ("CAF"). Our CarMax Sales Operations segment consists of all aspects of our auto merchandising and service operations, excluding financing provided by CAF. Our CAF segment consists solely of our own finance operation that provides vehicle financing through CarMax superstores.

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 May 31, 2013, we operated 121 used car superstores in 61 markets, comprising 47 mid-sized markets, 12 large markets and 2 small markets. We define mid-sized markets as those with television viewing populations generally between 600,000 and 2.5 million people. We also operated four new car franchises. During fiscal 2013, we sold 447,728 used cars, representing 98% of the total 455,583 vehicles we sold at retail.

We believe the CarMax consumer offer is distinctive within the auto 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 features low, no haggle prices; a broad selection of CarMax Quality Certified used vehicles; and

superior customer service. Our website, carmax.com, is a valuable tool for communicating the CarMax consumer offer, as well as a sophisticated search engine and efficient channel for customers who prefer to start their shopping online. Our financial results are driven by retailing used vehicles and associated items including vehicle financing, extended service plans (“ESPs”), guaranteed asset protection (“GAP”) 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 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 our on-site wholesale auctions. Vehicles repossessed and liquidated by CAF also are generally sold through our wholesale auctions. Wholesale auctions are generally held on a weekly or bi-weekly basis, and as of May 31, 2013, we conducted auctions at 57 used car superstores. During fiscal 2013, we sold 324,779 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.

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 earned on the sale of ESPs and GAP from the unrelated third parties.

We provide financing to qualified retail customers through CAF and our arrangements with several industry-leading financial institutions. Depending on the credit profile of the customer, the third-party finance providers generally either pay us or are



paid a fixed, pre-negotiated fee per contract. The fee amount is independent of any finance term offered to the customer; it does not vary based on the amount financed, the term of the loan, the interest rate or the loan-to-value ratio. We refer to the providers who pay us a fee as prime and nonprime providers, and we refer to the providers to whom we pay a fee as subprime providers. We periodically test additional third-party providers. We have no recourse liability for credit losses 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 41% of our retail vehicle unit sales in the first quarter of fiscal 2014. As of May 31, 2013, CAF serviced approximately 479,000 customer accounts in its \$6.33 billion portfolio of managed receivables.

Over the long term, we believe the primary driver for earnings growth will be used vehicle unit sales growth from both new stores and stores included in our comparable store base. We also believe that increased used vehicle unit sales will drive increased sales of wholesale vehicles and ancillary products and CAF income over time. 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.

In December 2008, we temporarily suspended store growth due to the weak economic and sales environment. We opened 3 superstores in fiscal 2011, 5 superstores in fiscal 2012 and 10 superstores in fiscal 2013. We currently plan to open 13 superstores in fiscal 2014 and between 10 and 15 superstores in each of the following 2 fiscal years. While we currently have more than 120 superstores, we are still in the midst of the national rollout of our retail concept, and as of May 31, 2013, we had used car superstores located in markets that comprised approximately 53% 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 2014 First Quarter Highlights

- § Net sales and operating revenues increased 19% to \$3.31 billion from \$2.77 billion in the first quarter of fiscal 2013. Net earnings grew 21% to \$146.7 million from \$120.7 million in the prior year period, while net earnings per diluted share grew 23% to \$0.64, compared with \$0.52.
- § Total used vehicle revenues increased 23% to \$2.70 billion from \$2.19 billion in the first quarter of fiscal 2013. Total used vehicle unit sales rose 22%, reflecting the combination of a 17% increase in comparable store used unit sales together with sales from newer stores not yet included in the comparable store base.
- § Total wholesale vehicle revenues increased 5% to \$490.7 million from \$467.8 million in the first quarter of fiscal 2013. Wholesale unit sales rose 6%, reflecting new store openings and a slightly stronger appraisal buy rate.
- § Total other sales and revenues increased 6% in the first quarter of fiscal 2014 as a 26% increase in ESP revenues was partially offset by a decrease in net third-party finance fees.
- § Total gross profit increased 17% to \$448.1 million compared with \$381.9 million in the first quarter of fiscal 2013, reflecting the increase in used and wholesale vehicle unit sales, as well as higher other gross profit.
- § Selling, general and administrative (“SG&A”) expenses increased 14% to \$290.2 million from \$253.6 million in the first quarter of fiscal 2013. The increase in SG&A expenses primarily reflected the 12% increase in our store base since the beginning of last year’s first quarter (representing the addition of 13 stores) and higher variable selling costs resulting from the 17% increase in comparable store used unit sales. SG&A per retail unit declined \$131 to \$2,086 versus \$2,217 in the prior year’s quarter as our comparable store used unit growth generated overhead leverage.
- § CAF income increased 16% to \$87.0 million compared with \$75.2 million in the first quarter of fiscal 2013. The improvement in CAF income was largely attributable to a 21% increase in average managed receivables.

§ In the first quarter of the fiscal year, net cash used in operating activities totaled \$77.6 million in fiscal 2014, compared with \$115.5 million in fiscal 2013. These amounts included increases in auto loan receivables of \$425.8 million and \$181.5 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 28, 2013. These policies relate to financing and securitization transactions, revenue recognition and income taxes.

## RESULTS OF OPERATIONS – CARMAX SALES OPERATIONS

### Net Sales And Operating Revenues

| (In millions)                          | Three Months Ended May 31 |            |          |
|--|---------------------------|------------|----------|
|  | 2013                      | 2012       | Change   |
| Used vehicle sales                     | \$ 2,701.8                | \$ 2,188.9 | 23.4 %   |
| New vehicle sales                      | 52.4                      | 55.5       | (5.5) %  |
| Wholesale vehicle sales                | 490.7                     | 467.8      | 4.9 %    |
| Other sales and revenues:              |                           |            |          |
| Extended service plan revenues         | 64.6                      | 51.3       | 26.0 %   |
| Service department sales               | 27.4                      | 24.8       | 10.3 %   |
| Third-party finance fees, net          | (25.8)                    | (13.8)     | (86.4) % |
| Total other sales and revenues         | 66.2                      | 62.3       | 6.4 %    |
| Total net sales and operating revenues | \$ 3,311.1                | \$ 2,774.4 | 19.3 %   |

### Unit Sales

|                    | Three Months Ended |         |
|--------------------|--------------------|---------|
|                    | May 31             |         |
|                    | 2013               | 2012    |
| Used vehicles      | 137,154            | 112,291 |
| New vehicles       | 1,949              | 2,107   |
| Wholesale vehicles | 88,356             | 83,541  |

## Average Selling Prices

|                    | Three Months Ended |           |
|--------------------|--------------------|-----------|
|                    | May 31             |           |
|                    | 2013               | 2012      |
| Used vehicles      | \$ 19,540          | \$ 19,285 |
| New vehicles       | \$ 26,788          | \$ 26,174 |
| Wholesale vehicles | \$ 5,388           | \$ 5,449  |

## Used Vehicle Sales Changes

|                      | Three Months |      |
|----------------------|--------------|------|
|                      | Ended May 31 |      |
|                      | 2013         | 2012 |
| Used vehicle units   | 22 %         | 3 %  |
| Used vehicle dollars | 23 %         | 6 %  |

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<br>Ended May 31 |      |
|----------------------|------------------------------|------|
|                      | 2013                         | 2012 |
| Used vehicle units   | 17 %                         | 0 %  |
| Used vehicle dollars | 18 %                         | 2 %  |

#### Wholesale Vehicle Sales Changes

|                           | Three Months<br>Ended May<br>31 |      |
|---------------------------|---------------------------------|------|
|                           | 2013                            | 2012 |
| Wholesale vehicle units   | 6 %                             | (2)% |
| Wholesale vehicle dollars | 5 %                             | (2)% |

#### Change in Used Car Superstore Base

|   | Three Months<br>Ended May 31 |      |
|---|------------------------------|------|
|   | 2013                         | 2012 |
| Used car superstores, beginning of period | 118                          | 108  |
| Superstore openings                       | 3                            | 2    |
| Used car superstores, end of period       | 121                          | 110  |

Used Vehicle Sales. The 23% increase in used vehicle revenues in the first quarter of fiscal 2014 resulted primarily from a 22% increase in used unit sales. The increase in used unit sales included a 17% 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 we believe reflected continued improvements in execution in our stores and an attractive consumer credit environment.

Wholesale Vehicle Sales. 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% increase in wholesale vehicle revenues in the first quarter of fiscal 2014 resulted from a 6% increase in wholesale unit sales, partially offset by a 1% reduction in wholesale vehicle average selling price. Wholesale unit sales benefited from opening new stores and a slightly stronger appraisal buy rate.

**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 net third-party finance fees. The fixed, per vehicle fees paid to us by prime and nonprime third-party finance providers may vary, reflecting the providers' differing levels of credit risk exposure. The fixed, per-vehicle fees that we pay to the subprime providers are reflected as an offset to finance fee revenues received from prime and nonprime providers.

Other sales and revenues increased 6% in the first quarter of fiscal 2014 as a 26% increase in ESP revenues was partially offset by a decrease in net third-party finance fees. The ESP revenue growth was driven by the 22% growth in used unit sales, as well as an increase in ESP penetration. The decrease in net third-party finance fees was the result of a mix shift among providers, including an increase in the percentage of our retail unit sales financed by the subprime providers to 21% in the first quarter of fiscal 2014 from 16% in the prior year period. The growth in subprime sales resulted from the combination of a change in the credit mix of our applicant flow, more attractive offers by the subprime providers and a delay in the 2013 tax refund season, which we believe shifted the timing of some subprime sales from the fourth quarter of fiscal 2013 to the first quarter of fiscal 2014. In previous years, the percentage of our retail unit sales financed by subprime providers excluded sales associated with a third party referral program. Sales from this program increased in recent quarters, and these sales are now included in this percentage for both the current and prior periods.

**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

| (In millions)                  | Three Months Ended May 31 |          |         |
|--------------------------------|---------------------------|----------|---------|
|                                | 2013                      | 2012     | Change  |
| Used vehicle gross profit      | \$ 303.9                  | \$ 249.4 | 21.9 %  |
| New vehicle gross profit       | 1.1                       | 1.6      | (32.5)% |
| Wholesale vehicle gross profit | 86.5                      | 81.9     | 5.6 %   |
| Other gross profit             | 56.6                      | 49.1     | 15.4 %  |
| Total                          | \$ 448.1                  | \$ 381.9 | 17.3 %  |

#### Gross Profit Per Unit

|                                | Three Months Ended May 31 |                  |                     |                  |
|--------------------------------|---------------------------|------------------|---------------------|------------------|
|                                | 2013                      | 2012             | 2013                | 2012             |
|                                | \$ per                    | % <sup>(2)</sup> | \$ per              | % <sup>(2)</sup> |
|                                | unit <sup>(1)</sup>       |                  | unit <sup>(1)</sup> |                  |
| Used vehicle gross profit      | \$ 2,216                  | 11.2             | \$ 2,221            | 11.4             |
| New vehicle gross profit       | \$ 551                    | 2.0              | \$ 755              | 2.9              |
| Wholesale vehicle gross profit | \$ 979                    | 17.6             | \$ 980              | 17.5             |
| Other gross profit             | \$ 407                    | 85.5             | \$ 429              | 78.8             |
| Total gross profit             | \$ 3,221                  | 13.5             | \$ 3,338            | 13.8             |

(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 22% in the first quarter of fiscal 2014 driven by the corresponding increase in used unit sales. Used vehicle gross profit per unit was consistent with last year's first quarter. We have been able to manage to a relatively consistent gross profit per used unit over the last several years.

**Wholesale Vehicle Gross Profit.** Wholesale vehicle gross profit increased 6% in the first quarter of fiscal 2014 reflecting the 6% increase in wholesale unit sales. Wholesale gross profit per unit was consistent with last year's first

quarter.

**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. Third-party finance fees are reported net of the fees we pay to third-party subprime finance providers. Accordingly, changes in the relative mix of the other gross profit components can affect the composition and amount of other gross profit.

Other gross profit increased 15% in the first quarter of fiscal 2014, as the increase in ESP gross profit was partially offset by the reduction in net third-party finance fees. Service department gross profit increased \$6.1 million primarily due to the leverage of service overhead costs resulting from strong used unit sales growth.

**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 retail prices. However, increases in average vehicle selling prices benefit CAF income, to the extent the average amount financed also increases.



## Selling, General and Administrative Expenses

## Components of SG&amp;A Expense

| (In millions)                            | Three Months Ended May 31 |          |        |
|--|---------------------------|----------|--------|
|  | 2013                      | 2012     | Change |
| Compensation and benefits <sup>(1)</sup> | \$ 172.1                  | \$ 143.4 | 20.0 % |
| Store occupancy costs                    | 52.5                      | 47.8     | 9.7 %  |
| Advertising expense                      | 27.1                      | 25.7     | 5.6 %  |
| Other overhead costs <sup>(2)</sup>      | 38.5                      | 36.7     | 5.0 %  |
| Total SG&A expenses                      | \$ 290.2                  | \$ 253.6 | 14.4 % |

<sup>(1)</sup> Excludes compensation and benefits related to reconditioning and vehicle repair service, which is included in cost of sales.

<sup>(2)</sup> Includes IT expenses, insurance, non-CAF bad debt, travel, preopening and relocation costs, charitable contributions and other administrative expenses.

SG&A expenses increased 14% in the first quarter of fiscal 2014. The increase primarily reflected the combination of the 12% increase in our store base since the beginning of last year's first quarter (representing the addition of 13 stores) and higher variable selling costs resulting from the 17% increase in comparable store used unit sales. SG&A per retail unit declined \$131 to \$2,086 versus \$2,217 in the prior year's quarter, as our comparable store used unit growth generated overhead leverage.

Income Taxes. The effective income tax rate was 38.2% in the first quarter of fiscal 2014 versus 38.3% in the first quarter of fiscal 2013.

## RESULTS OF OPERATIONS – CARMAX AUTO FINANCE INCOME

CAF provides financing to qualified customers purchasing vehicles at CarMax. 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 the

company's processes and systems, transparency of pricing, vehicle quality and the integrity of the information collected at the time the customer applies for credit provide a unique and ideal environment in which to procure high quality auto loans, both for CAF and for the third-party finance providers.

We believe CAF enables us to capture additional sales, profits and cash flows while managing our reliance on third-party finance sources. Management regularly analyzes CAF's operating results by assessing the competitiveness of our consumer offer, profitability, the performance of the auto loan receivables including trends in credit losses and delinquencies, and CAF direct expenses.

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. 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.

## Components of CAF Income

| (In millions)   | Three Months Ended May 31 |                  |            |                  |
|---|---------------------------|------------------|------------|------------------|
|   | 2013                      | % <sup>(1)</sup> | 2012       | % <sup>(1)</sup> |
| Interest margin:                                      |                           |                  |            |                  |
| Interest and fee income                               | \$ 133.5                  | 8.7              | \$ 120.3   | 9.5              |
| Interest expense                                      | (22.8)                    | (1.5)            | (25.1)     | (2.0)            |
| Total interest margin                                 | 110.7                     | 7.2              | 95.2       | 7.5              |
| Provision for loan losses                             | (11.3)                    | (0.7)            | (9.2)      | (0.7)            |
| Total interest margin after provision for loan losses | 99.4                      | 6.5              | 86.0       | 6.8              |
| Direct expenses:                                      |                           |                  |            |                  |
| Payroll and fringe benefit expense                    | (5.5)                     | (0.4)            | (5.3)      | (0.4)            |
| Other direct expenses                                 | (6.9)                     | (0.4)            | (5.5)      | (0.4)            |
| Total direct expenses                                 | (12.4)                    | (0.8)            | (10.8)     | (0.9)            |
| CarMax Auto Finance income                            | \$ 87.0                   | 5.7              | \$ 75.2    | 5.9              |
| Total average managed receivables                     | \$ 6,152.5                |                  | \$ 5,075.2 |                  |

<sup>(1)</sup> Annualized percent of total average managed receivables.

## CAF Origination Information

|                                    | Three Months Ended May 31 <sup>(1)</sup> |   |          |   |
|------------------------------------|--|---|----------|---|
|                                    | 2013                                     |   | 2012     |   |
| Net loans originated (in millions) | \$ 1,120.2                               |   | \$ 786.8 |   |
| Vehicle units financed             | 57,662                                   |   | 41,660   |   |
| Penetration rate <sup>(2)</sup>    | 41.5                                     | % | 36.4     | % |
| Weighted average contract rate     | 7.0                                      | % | 8.9      | % |
| Weighted average term (in months)  | 65.7                                     |   | 65.5     |   |

<sup>(1)</sup> All information relates to loans originated net of estimated 3-day payoffs and vehicle returns.

<sup>(2)</sup> Vehicle units financed as a percentage of total retail units sold.

CAF income increased 16% in the first quarter of fiscal 2014, primarily as a result of the increase in average managed receivables. CAF's average managed receivables increased 21% in the first quarter of fiscal 2014 to \$6.15 billion, driven by the growth in CAF origination volume in recent years. Origination volumes have benefited from an

increase in CAF's loan penetration rate, as well as our retail unit sales growth and higher average amounts financed. The total interest margin, which reflects the spread between interest and fees charged to consumers and our funding costs, declined to 7.2% of average managed receivables in the first quarter of fiscal 2014, from 7.5% in the corresponding prior year period. In the first quarter of fiscal 2014, the provision for loan losses was 0.7% of average managed receivables, similar to the prior year period. The provision for loan losses is the periodic expense of maintaining an adequate allowance for loan losses.

Net loans originated increased by 42% to \$1.12 billion compared with the prior year period. Penetration increased to 41.5% compared with 36.4% in the prior year period. The growth in CAF origination volume and penetration resulted from a combination of an increase in the number of higher credit quality applicants and favorable response to our offers. In recent quarters, we have responded to competitive pressure by providing more competitive offers in select customer segments, which resulted in the weighted average contract rate declining to 7.0%. Changes in the interest margin on new originations will affect CAF income over time, as loans amortize within the portfolio of managed receivables. Rising interest rates or further competitive pressure on consumer rates could result in further compression in the interest margin on new originations.

## Allowance for Loan Losses

| (In millions)                     | Three Months Ended May 31 |                  |         |                  |
|-----------------------------------|---------------------------|------------------|---------|------------------|
|                                   | 2013                      | % <sup>(1)</sup> | 2012    | % <sup>(1)</sup> |
| Balance as of beginning of period | \$ 57.3                   | 1.0              | \$ 43.3 | 0.9              |
| Charge-offs                       | (26.4)                    |                  | (20.6)  |                  |
| Recoveries                        | 18.7                      |                  | 14.7    |                  |
| Provision for loan losses         | 11.3                      |                  | 9.2     |                  |
| Balance as of end of period       | \$ 60.9                   | 1.0              | \$ 46.6 | 0.9              |

<sup>(1)</sup> 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 allowance for loan losses increased to \$60.9 million, or 1.0% of managed receivables, as of May 31, 2013, compared with \$46.6 million, or 0.9%, as of May 31, 2012. The increase in the allowance reflected the growth in managed receivables, partially offset by the net effects of low unit charge-offs and strong recovery rates relative to historical norms.

## Past Due Account Information

| (In millions)   | As of May 31 |            | As of February 28 or 29 |            |
|---|--------------|------------|-------------------------|------------|
|   | 2013         | 2012       | 2013                    | 2012       |
| Accounts 31+ days past due                                      | \$ 154.4     | \$ 128.6   | \$ 154.2                | \$ 116.5   |
| Ending managed receivables                                      | \$ 6,334.7   | \$ 5,154.2 | \$ 5,933.3              | \$ 4,981.8 |
| Past due accounts as a percentage of ending managed receivables | 2.44         | % 2.50     | % 2.60                  | % 2.34     |

## Credit Loss Information

| (In millions)                            | Three Months Ended May 31 |        |
|--|---------------------------|--------|
|  | 2013                      | 2012   |
| Net credit losses on managed receivables | \$ 7.7                    | \$ 5.9 |

|   |            |   |            |   |
|---|------------|---|------------|---|
| Total average managed receivables   | \$ 6,152.5 |   | \$ 5,075.2 |   |
| Annualized net credit losses as a percentage of total average managed receivables | 0.50       | % | 0.46       | % |
| Average recovery rate   | 59.2       | % | 62.5       | % |

As of May 31, 2013, past due accounts as a percentage of ending managed receivables declined modestly compared with May 31, 2012. For the first quarter of fiscal 2014, net credit losses increased to \$7.7 million, or 0.50% of average managed receivables, compared with \$5.9 million, or 0.46%, for the prior year period. The increase in net credit losses largely reflected the growth in managed receivables.

The average recovery rate represents the average percentage of the outstanding principal balance we receive when a vehicle is repossessed and liquidated, generally at our wholesale auctions. Through February 28, 2013, the annual recovery rate has ranged from a low of 42% to a high of 60%, and it is primarily affected by changes in the wholesale market pricing environment.

#### OPERATIONS OUTLOOK

**Planned Superstore Openings.** We opened three used car superstores during the first quarter of fiscal 2014, entering the Harrisonburg, Virginia market and the Savannah and Columbus markets in Georgia. We plan to open a total of 13 superstores in fiscal 2014 and between 10 and 15 superstores in each of the following 2 fiscal years. We currently estimate capital expenditures will total approximately \$300 million in fiscal 2014.

We currently plan to open the following superstores within 12 months from May 31, 2013:

| Location                      | Television Market    | Market Status | Planned Opening Date |
|-------------------------------|----------------------|---------------|----------------------|
| Katy, Texas <sup>(1)</sup>    | Houston              | Existing      | Q2 Fiscal 2014       |
| Fairfield, California         | Sacramento           | Existing      | Q2 Fiscal 2014       |
| Jackson, Tennessee            | Jackson              | New           | Q3 Fiscal 2014       |
| Brandywine, Maryland          | Washington/Baltimore | Existing      | Q3 Fiscal 2014       |
| St. Louis, Missouri           | St. Louis            | New           | Q3 Fiscal 2014       |
| St. Peters, Missouri          | St. Louis            | New           | Q4 Fiscal 2014       |
| Newark, Delaware              | Philadelphia         | New           | Q4 Fiscal 2014       |
| King of Prussia, Pennsylvania | Philadelphia         | New           | Q4 Fiscal 2014       |
| Frederick, Maryland           | Washington/Baltimore | Existing      | Q4 Fiscal 2014       |
| Elk Grove, California         | Sacramento           | Existing      | Q4 Fiscal 2014       |
| Henrietta, New York           | Rochester            | New           | Q1 Fiscal 2015       |
| Dothan, Alabama               | Dothan               | New           | Q1 Fiscal 2015       |
| Mechanicsburg, Pennsylvania   | Harrisburg           | Existing      | Q1 Fiscal 2015       |
| Spokane, Washington           | Spokane              | New           | Q1 Fiscal 2015       |

<sup>(1)</sup> Superstore opened in June 2013.

Normal construction, permitting or other scheduling delays could shift the opening dates into a later period.

## FINANCIAL CONDITION

### Liquidity and Capital Resources.

Our primary ongoing cash requirements are to fund our existing operations, new superstore expansion (including capital expenditures and inventory purchases) and CAF. Our primary ongoing sources of liquidity include existing cash balances, funds provided by operations, proceeds from securitization transactions or other funding arrangements, and borrowings under our revolving credit facility.

**Operating Activities.** During the first quarter of the fiscal year, net cash used in operating activities totaled \$77.6 million in fiscal 2014 and \$115.5 million in fiscal 2013. These amounts included increases in auto loan receivables of \$425.8 million and \$181.5 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.

As of May 31, 2013, total inventory was \$1.40 billion, representing a decrease of \$119.6 million, or 8%, compared with the balance at the start of fiscal 2014. We had 8% fewer used vehicles in inventory as of May 31, 2013, compared with the start of the fiscal year, reflecting a return to more normal levels of inventory after having built inventories in the latter portion of fiscal 2013 to better position ourselves for seasonal sales opportunities. Compared with May 31, 2012, inventories increased \$188.0 million, or 16%, reflecting the inventories added to support the 11 new stores opened since that date and our comparable store sales growth.

**Investing Activities.** During the first quarter of the fiscal year, net cash used in investing activities totaled \$46.5 million in fiscal 2014 compared with \$20.4 million in fiscal 2013. Capital expenditures were relatively similar at \$42.0 million in fiscal 2014 versus \$47.6 million in the prior year period. Capital expenditures primarily include real estate acquisitions for planned future superstore openings and store construction costs. We maintain a multi-year pipeline of sites to support our superstore growth, so portions of capital spending in any one year may relate to superstores that we plan to open in subsequent fiscal years. After ramping superstore growth in recent years, our superstore opening pace has become more consistent, with 10 superstores opened in fiscal 2013, 13 superstores planned for fiscal 2014, and 10 to 15 superstores planned for each of the following 2 fiscal years.

Historically, capital expenditures have been funded with internally generated funds, debt and sale-leaseback transactions. No sale-leasebacks have been completed since fiscal 2009.

As of May 31, 2013, we owned 63 and leased 58 of our 121 used car superstores.



During the first quarter of the fiscal year, restricted cash from collections on auto loan receivables increased \$16.4 million in fiscal 2014 versus a decrease of \$22.0 million in fiscal 2013. These collections vary depending on the timing of the receipt of principal and interest payments on securitized auto loan receivables, the change in average managed receivables and the funding vehicle utilized.

**Financing Activities.** During the first quarter of the fiscal year, net cash provided by financing activities totaled \$400.0 million in fiscal 2014 compared with \$149.7 million in fiscal 2013. Included in these amounts were net increases in total non-recourse notes payable of \$512.3 million and \$141.1 million, respectively, which were used to provide the financing for the majority of the increases of \$425.8 million and \$181.5 million, respectively, in auto loan receivables. During fiscal 2014, cash provided by financing activities was reduced by \$130.2 million of stock repurchases.

#### Total Debt and Cash and Cash Equivalents

|  | As of May 31 | As of               |
|--|--------------|---------------------|
| (In thousands)                             | 2013         | February 28<br>2013 |
| Borrowings under revolving credit facility | \$ 972       | \$ 355              |
| Finance and capital lease obligations      | 349,795      | 353,591             |
| Non-recourse notes payable                 | 6,367,355    | 5,855,090           |
| Total debt                                 | \$ 6,718,122 | \$ 6,209,036        |
| Cash and cash equivalents                  | \$ 725,267   | \$ 449,364          |

We have a \$700 million unsecured revolving credit facility, which expires in August 2016. Borrowings under this credit facility are available for working capital and general corporate purposes, and the unused portion is fully available to us. See Note 9 for additional information on the revolving credit facility agreement.

The credit facility agreement contains representations and warranties, conditions and covenants. If these requirements were not met, all amounts outstanding or otherwise owed could become due and payable immediately and other limitations could be placed on our ability to use any available borrowing capacity.

CAF auto loan receivables are primarily funded through securitization transactions. Our securitizations are structured to legally isolate the auto loan receivables, and we would not expect to be able to access the assets of our securitization vehicles, even in insolvency, receivership or conservatorship proceedings. Similarly, the investors in the non-recourse notes payable 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 do, however, continue to have the rights associated with the interest we retain in these securitizations vehicles.

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. The current portion of the non-recourse notes payable represents principal payments that are due to be distributed in the following period.

As of May 31, 2013, \$5.43 billion of non-recourse notes payable was outstanding related to term securitizations. These notes payable accrue interest at fixed rates and have scheduled maturities through November 2019, but may mature earlier or later, depending on the repayment rate of the underlying auto loan receivables. During the first quarter of fiscal 2014, we completed one term securitization, funding a total of \$920.0 million of auto loan receivables.

Our term securitizations typically contain an option to repurchase the securitized receivables when the outstanding balance in the pool of auto loan receivables falls below 10% of the original pool balance. During the first quarter of fiscal 2014, we exercised this option on a term securitization that had originally been issued in 2009, and for which CarMax had provided \$140.0 million of capital, or 14% of the transaction, in the form of subordinated bonds. Upon the exercise of this option, we funded substantially all of the remaining receivables through our warehouse facilities.

As of May 31, 2013, \$941.0 million of non-recourse notes payable was outstanding related to our warehouse facilities. The combined warehouse facility limit is \$1.7 billion, and the unused warehouse capacity totaled \$759.0 million. Of the combined warehouse facility limit, \$800 million will expire in August 2013 and \$900 million will expire in February 2014. 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. See Notes 2 and 9 for additional information on the warehouse facilities.

The securitization agreements related to the warehouse facilities include various representations and warranties, covenants and performance triggers. If these requirements 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.

We expect that cash generated by operations and proceeds from securitization transactions or other funding arrangements, sale-leaseback transactions and borrowings under existing, new or expanded credit facilities will be sufficient to fund CAF, capital expenditures and working capital for the foreseeable future. We anticipate that we will be able to enter into new, or renew or expand existing, funding arrangements to meet our future funding needs. However, based on conditions in the credit markets, the cost for these arrangements could be materially higher than historical levels and the timing and capacity of these transactions could be dictated by market availability rather than our requirements.

In October 2012, our board of directors authorized the repurchase of up to \$300 million of our common stock. In January 2013, our board of directors authorized an additional \$500 million for the repurchase of our common stock. Purchases may be made in open market or privately negotiated transactions at management's discretion and the timing and amount of repurchases are determined based on share price, market conditions, legal requirements and other factors. Shares repurchased are deemed authorized but unissued shares of common stock.

For the three months ended May 31, 2013, we repurchased 2.9 million shares of common stock at an average purchase price of \$42.29 per share. As of May 31 2013, \$463.5 million was available for repurchase under the authorizations, which expire on December 31, 2014. Amounts reported as the repurchase and retirement of common stock on our statement of cash flows may reflect timing differences in trade and settlement dates on stock repurchase transactions occurring at the end a reporting period.

**Fair Value Measurements.** We report money market securities, mutual fund investments and derivative instruments at fair value. See Note 6 for more information on fair value measurements.



## FORWARD-LOOKING STATEMENTS

We caution readers that the statements contained in this report about our future business plans, operations, opportunities, or prospects, including without limitation any statements or factors regarding expected sales, margins, expenditures, CAF income, or earnings, are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements are based upon management's current knowledge and assumptions about future events and involve risks and uncertainties that could cause actual results to differ materially from anticipated results. We disclaim any intent or obligation to update these statements. Among the factors that could cause actual results and outcomes to differ materially from those contained in the forward-looking statements are the following:

- § Changes in general or regional U.S. economic conditions.
- § Changes in the competitive landscape within our industry.
- § Changes in the availability or cost of capital and working capital financing, including changes related to the asset-backed securitization market.
- § Changes in consumer credit availability related to our third-party financing providers.
- § Significant changes in retail prices for used and new vehicles.
- § A reduction in the availability of or access to sources of inventory.
- § Factors related to the regulatory and legislative environment in which we operate.
- § Events that damage our reputation or harm the perception of the quality of our brand.
- § Security breaches or other events that result in the misappropriation, loss or other unauthorized disclosure of confidential customer or associate information.
- § Factors related to geographic growth, including the inability to acquire or lease suitable real estate at favorable terms or to effectively manage our growth.
- § The loss of key employees from our store, regional or corporate management teams or a significant increase in labor costs.
- § The failure of key information systems.
- § The effect of various litigation matters.
- § Adverse conditions affecting one or more automotive manufacturers or manufacturer recalls.
- § The occurrence of severe weather events.
- § Factors related to the seasonal fluctuations in our business.
- § Factors related to the geographic concentration of our superstores.
- § The effect of new accounting requirements or changes to U.S. generally accepted accounting principles.
- § Acts of terrorism, the outbreak of war or other significant national or international events.

For more details on factors that could affect expectations, see Part II, Item 1A, "Risk Factors" on Page 37 of this report, our Annual Report on Form 10-K for the fiscal year ended February 28, 2013, and our quarterly or current reports as filed with or furnished to the Securities and Exchange Commission ("SEC"). Our filings are publicly available on our investor information home page at [investor.carmax.com](http://investor.carmax.com). Requests for information may also be made to our Investor Relations Department by email to [investor\\_relations@carmax.com](mailto:investor_relations@carmax.com) or by calling 1-804-747-0422, ext. 4391.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no material changes to our market risk since February 28, 2013. For information on our exposure to market risk, refer to Part II, Item 7A, “Quantitative and Qualitative Disclosures about Market Risk,” contained in our Annual Report on Form 10-K for the year ended February 28, 2013.

Item 4. Controls and Procedures

Disclosure. We maintain disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (“Exchange Act”)) that are designed to ensure that information required to be disclosed in our reports filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms. Our disclosure controls and procedures are also designed to ensure that this information is accumulated and communicated to management, including the chief executive officer (“CEO”) and the chief financial officer (“CFO”), as appropriate to allow timely decisions regarding required disclosure.

As of the end of the period covered by this report, with the participation of the CEO and CFO, we evaluated the effectiveness of our disclosure controls and procedures. Based upon that evaluation, the CEO and CFO concluded that our disclosure controls and procedures were effective as of the end of the period.

Internal Control over Financial Reporting. There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during the quarter ended May 31, 2013, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

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; (5) unfair competition; and (6) 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 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 a part of the lawsuit.

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; (3) unfair competition; and (4) 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 individual basis, which the court granted on November 21, 2011. The plaintiffs appealed the court's ruling to the California Court of Appeal. On March 26, 2013, the California Court of Appeal reversed the trial court's order granting CarMax's motion to compel arbitration. CarMax is pursuing an appeal of this decision and has filed a Petition for Review with the California Supreme Court. 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.

On May 29, 2013, CarMax Auto Superstores, Inc. and CarMax Business Services, LLC (collectively, "CarMax") filed a lawsuit against eVox Productions, LLC ("eVox") in the United States District Court for the Eastern District of Virginia (the "Virginia Action") seeking a declaratory judgment that, among other things, CarMax did not infringe eVox's copyrights of certain vehicle photographs. On June 5, 2013, eVox filed a lawsuit against CarMax, Transtock, Inc., Dean Siracusa and Does 1 through 10 in the United States District Court for the Central District of California seeking a judgment that CarMax: (i) infringed eVox's copyrights of certain vehicle photographs; (ii) infringed eVox's trademarks; and (iii) engaged in false advertising and unfair competition. On June 19, 2013, eVox filed a motion to

dismiss, transfer or stay the Virginia Action. eVox seeks injunctive relief, actual or statutory damages, a finding of willful infringement, an accounting, trebled damages, attorneys' fees and interest. We believe that insurance coverage will be available to CarMax for some or all of this matter. We are unable to make a reasonable estimate of the amount or range of loss that could result from an unfavorable outcome in this matter.

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 1A. Risk Factors

In connection with information set forth in this Form 10-Q, the factors discussed under “Risk Factors” in our Form 10-K for fiscal year ended February 28, 2013, should be considered. These risks could materially and adversely affect our business, financial condition, and results of operations. There have been no material changes to the factors discussed in our Form 10 K.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

On October 17, 2012, our board of directors authorized the repurchase of up to \$300 million of our common stock. The authorization expires on December 31, 2013. In January 2013, our board of directors authorized an additional \$500 million for the repurchase of our common stock. This \$500 million authorization expires on December 31, 2014. Purchases may be made in open market or privately negotiated transactions at management’s discretion and the timing and amount of repurchases are determined based on share price, market conditions, legal requirements and other factors. Shares repurchased are deemed authorized but unissued shares of common stock.

The following table provides information relating to the company’s repurchase of common stock for the first quarter of fiscal 2014. The table does not include transactions related to employee equity awards or the exercises of employee stock options.

| Period             | Total Number<br>of Shares<br>Purchased | Average<br>Price<br>Paid<br>per Share | Total Number<br>of Shares Purchased<br>as Part of Publicly<br>Announced Program | Approximate<br>Dollar Value<br>of Shares that<br>May Yet Be<br>Purchased Under<br>the Program |
|--------------------|--|---------------------------------------|---|---|
| March 1 - 31, 2013 | 1,521,300                              | \$ 40.77                              | 1,521,300   | \$ 526,082,951  |
| April 1 - 30, 2013 | 966,813                                | \$ 42.55                              | 966,813   | \$ 484,942,750  |
| May 1 - 31, 2013   | 457,509                                | \$ 46.77                              | 457,509   | \$ 463,545,031  |
| Total              | 2,945,622                              |                                       | 2,945,622   |   |

Item 4. Mine Safety Disclosures

None.

Page 38

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Item 6. Exhibits

10.1 Form of Directors Stock Option Grant Agreement between CarMax and certain non-employee members of the CarMax, Inc. Board of Directors, filed herewith.

10.2 Form of Stock Grant Notice Letter from CarMax, Inc. to certain non-employee members of the CarMax, Inc. Board of Directors, filed herewith.

31.1 Certification of the Chief Executive Officer Pursuant to Rule 13a-14(a), filed herewith.

31.2 Certification of the Chief Financial Officer Pursuant to Rule 13a-14(a), filed herewith.

32.1 Certification of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, filed herewith.

32.2 Certification of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, filed herewith.

101.INS XBRL Instance Document

101.SCH XBRL Taxonomy Extension Schema Document

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document

101.LAB XBRL Taxonomy Extension Label Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CARMAX, INC.

By: /s/ Thomas J. Folliard  
Thomas J. Folliard  
President and  
Chief Executive Officer

By: /s/ Thomas W. Reedy  
Thomas W. Reedy  
Executive Vice President and  
Chief Financial Officer

July 9, 2013

Page 40

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EXHIBIT INDEX

- 10.1 Form of Directors Stock Option Grant Agreement between CarMax and certain non-employee members of the CarMax, Inc. Board of Directors, filed herewith.
- 10.2 Form of Stock Grant Notice Letter from CarMax, Inc. to certain non-employee members of the CarMax, Inc. Board of Directors, filed herewith.
- 31.1 Certification of the Chief Executive Officer Pursuant to Rule 13a-14(a), filed herewith.
- 31.2 Certification of the Chief Financial Officer Pursuant to Rule 13a-14(a), filed herewith.
- 32.1 Certification of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, filed herewith.
- 32.2 Certification of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, filed herewith.
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document