LITHIA MOTORS INC
Form 10-Q
October 28, 2016
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2016

OR

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

For the transition period from ___ to

Commission file number: **001-14733**

LITHIA MOTORS, INC.
(Exact name of registrant as specified in its charter)

Oregon (State or other jurisdiction of incorporation or organization)	**93-0572810** (I.R.S. Employer Identification No.)
150 N. Bartlett Street, Medford, Oregon (Address of principal executive offices)	**97501** (Zip Code)

Registrant's telephone number, including area code: **541-776-6401**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes [X] No [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. Large accelerated filer [X] Accelerated filer [ ] Non-accelerated filer [ ] (Do not check if a smaller reporting company) Smaller reporting company [ ]

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

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

Class A common stock without par value	**25,173,982**
Class B common stock without par value	**1,762,231**
(Class)	Outstanding at October 28, 2016

LITHIA MOTORS, INC.

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LITHIA MOTORS, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

(In thousands)

(Unaudited)

	September 30, 2016	December 31, 2015
Assets		
Current Assets:		
Cash and cash equivalents	$24,116	$45,008
Accounts receivable, net of allowance for doubtful accounts of $4,413 and $2,243	317,664	308,462
Inventories, net	1,657,693	1,470,987
Other current assets	33,225	54,408
Total Current Assets	2,032,698	1,878,865
Property and equipment, net of accumulated depreciation of $157,940 and $137,853	991,721	876,660
Goodwill	219,021	213,220
Franchise value	163,220	157,699
Other non-current assets	156,946	100,855
Total Assets	$3,563,606	$3,227,299
Liabilities and Stockholders' Equity		
Current Liabilities:		
Floor plan notes payable	$73,762	$48,083
Floor plan notes payable: non-trade	1,351,940	1,265,872
Current maturities of long-term debt	26,674	38,891
Trade payables	78,442	70,871
Accrued liabilities	204,361	167,108
Total Current Liabilities	1,735,179	1,590,825
Long-term debt, less current maturities	727,191	606,463
Deferred revenue	77,577	66,734
Deferred income taxes	58,721	53,129
Other long-term liabilities	98,848	81,984
Total Liabilities	2,697,516	2,399,135
Stockholders' Equity:		
Preferred stock - no par value; authorized 15,000 shares; none outstanding	—	—
Class A common stock - no par value; authorized 100,000 shares; issued and outstanding 23,405 and 23,676	167,596	258,410
	219	316

Class B common stock - no par value; authorized 25,000 shares; issued and outstanding 1,762 and 2,542		
Additional paid-in capital	39,359	38,822
Accumulated other comprehensive loss	—	(277)
Retained earnings	658,916	530,893
Total Stockholders' Equity	866,090	828,164
Total Liabilities and Stockholders' Equity	$3,563,606	$3,227,299

See accompanying condensed notes to consolidated financial statements.

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LITHIA MOTORS, INC. AND SUBSIDIARIES

Consolidated Statements of Operations

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	**2015**	**2016**	**2015**
Revenues:				
New vehicle	$1,297,511	$1,227,080	$3,602,603	$3,384,408
Used vehicle retail	580,885	505,885	1,667,258	1,457,617
Used vehicle wholesale	75,271	69,472	207,131	198,476
Finance and insurance	87,709	76,633	246,390	213,700
Service, body and parts	217,148	189,796	616,088	545,966
Fleet and other	11,443	15,979	46,697	70,803
Total revenues	2,269,967	2,084,845	6,386,167	5,870,970
Cost of sales:				
New vehicle	1,221,668	1,149,923	3,387,132	3,176,135
Used vehicle retail	512,076	443,598	1,466,947	1,273,195
Used vehicle wholesale	74,353	68,892	202,897	194,329
Service, body and parts	112,806	95,846	317,028	276,828
Fleet and other	11,803	15,399	45,684	68,272
Total cost of sales	1,932,706	1,773,658	5,419,688	4,988,759
Gross profit	337,261	311,187	966,479	882,211
Asset impairments	3,498	4,131	10,494	14,391
Selling, general and administrative	228,134	223,728	662,766	610,956
Depreciation and amortization	12,206	10,531	36,372	30,544
Operating income	93,423	72,797	256,847	226,320
Floor plan interest expense	(6,186)	(4,951)	(18,304)	(14,255)
Other interest expense, net	(5,647)	(4,900)	(16,608)	(14,700)
Other expense, net	(1,513)	(307)	(4,534)	(1,031)
Income before income taxes	80,077	62,639	217,401	196,334
Income tax provision	(26,036)	(19,248)	(71,662)	(61,067)
Net income	$54,041	$43,391	$145,739	$135,267
Basic net income per Class A and Class B share	$2.15	$1.65	$5.72	$5.14
Shares used in basic per share calculations	25,194	26,289	25,490	26,304
Diluted net income per Class A and Class B share	$2.14	$1.64	$5.69	$5.10
Shares used in diluted per share calculations	25,290	26,480	25,598	26,500
Cash dividend declared per Class A and Class B share	$0.25	$0.20	$0.70	$0.56

See accompanying condensed notes to consolidated financial statements.

LITHIA MOTORS, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

(In thousands)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	**2015**	**2016**	**2015**
Net income	$54,041	$43,391	$145,739	$135,267
Other comprehensive income, net of tax:				
Gain on cash flow hedges, net of tax expense of $0, $103, $175 and $283, respectively	—	161	277	465
Comprehensive income	$54,041	$43,552	$146,016	$135,732

See accompanying condensed notes to consolidated financial statements.

LITHIA MOTORS, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Nine Months Ended September 30,	
	2016	**2015**
Cash flows from operating activities:		
Net income	$145,739	$135,267
Adjustments to reconcile net income to net cash provided by operating activities:		
Asset impairments	10,494	14,391
Depreciation and amortization	36,372	30,544
Stock-based compensation	8,665	8,579
(Gain) loss on disposal of other assets	(4,299)	27
Gain on disposal of franchise	(1,102)	(5,919)
Deferred income taxes	9,782	(7,955)
Excess tax benefit from share-based payment arrangements	(4,388)	(4,923)
(Increase) decrease (net of acquisitions and dispositions):		
Trade receivables, net	(5,911)	9,685
Inventories	(85,564)	(132,407)
Other assets	4,627	(5,339)
Increase (decrease) (net of acquisitions and dispositions):		
Floor plan notes payable	18,122	5,604
Trade payables	6,153	7,768
Accrued liabilities	32,874	16,949
Other long-term liabilities and deferred revenue	18,227	34,651
Net cash provided by operating activities	189,791	106,922
Cash flows from investing activities:		
Capital expenditures	(81,363)	(62,159)
Proceeds from sales of assets	1,756	229
Cash paid for other investments	(22,279)	(20,693)
Cash paid for acquisitions, net of cash acquired	(199,435)	(34,920)
Proceeds from sales of stores	11,837	12,966
Net cash used in investing activities	(289,484)	(104,577)
Cash flows from financing activities:		
Borrowings on floor plan notes payable, net: non-trade	93,817	36,204
Borrowings on lines of credit	841,623	878,340
Repayments on lines of credit	(744,494)	(939,817)
Principal payments on long-term debt, scheduled	(12,217)	(11,048)
Principal payments on long-term debt and capital leases, other	(5,903)	(9,189)

Proceeds from issuance of long-term debt	22,816	75,675
Proceeds from issuance of common stock	5,191	4,313
Repurchase of common stock	(108,597)	(24,198)
Excess tax benefit from share-based payment arrangements	4,388	4,923
Dividends paid	(17,823)	(14,739)
Net cash provided by financing activities	78,801	464
(Decrease) increase in cash and cash equivalents	(20,892)	2,809
Cash and cash equivalents at beginning of period	45,008	29,898
Cash and cash equivalents at end of period	$24,116	$32,707
Supplemental disclosure of cash flow information:		
Cash paid during the period for interest	$36,641	$31,140
Cash paid during the period for income taxes, net	29,478	50,917
Supplemental schedule of non-cash activities:		
Debt issued in connection with acquisitions	$—	$2,160
Non-cash assets transferred in connection with acquisitions	2,637	—
Debt assumed in connection with acquisitions	19,657	—
Acquisition of capital leases in connection with acquisitions	11,366	—
Floor plan debt paid in connection with store disposals	5,284	4,400

See accompanying condensed notes to consolidated financial statements.

LITHIA MOTORS, INC. AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Interim Financial Statements

Basis of Presentation

These condensed Consolidated Financial Statements contain unaudited information as of September 30, 2016 and for the three and nine months ended September 30, 2016 and 2015. The unaudited interim financial statements have been prepared pursuant to the rules and regulations for reporting on Form 10-Q. Accordingly, certain disclosures required by accounting principles generally accepted in the United States of America for annual financial statements are not included herein. In management’s opinion, these unaudited financial statements reflect all adjustments (which include only normal recurring adjustments) necessary for a fair presentation of the information when read in conjunction with our 2015 audited Consolidated Financial Statements and the related notes thereto. The financial information as of December 31, 2015 is derived from our Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 26, 2016. The interim condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and the notes thereto included in our 2015 Annual Report on Form 10-K. The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for the full year.

Reclassifications

Certain reclassifications of amounts previously reported have been made to the accompanying condensed Consolidated Financial Statements to maintain consistency and comparability between periods presented. These reclassifications had no impact on previously reported net income.

Note 2. Accounts Receivable

Accounts receivable consisted of the following (in thousands):

	September 30, 2016	**December 31, 2015**
Contracts in transit	$ 162,679	$ 168,460
Trade receivables	37,796	33,749
Vehicle receivables	36,634	36,470

Manufacturer receivables	65,549	59,215
Auto loan receivables	64,657	42,490
Other receivables	1,636	3,033
	368,951	343,417
Less: Allowance	(4,413)	(2,243)
Less: Long-term portion of accounts receivable, net	(46,874)	(32,712)
Total accounts receivable, net	$ 317,664	$ 308,462

Accounts receivable classifications include the following:

- Contracts in transit are receivables from various lenders for the financing of vehicles that we have arranged on behalf of the customer and are typically received approximately ten days after selling a vehicle.
- Trade receivables are comprised of amounts due from customers for open charge accounts, lenders for the commissions earned on financing and others for commissions earned on service contracts and insurance products.
- Vehicle receivables represent receivables for the portion of the vehicle sales price paid directly by the customer.
- Manufacturer receivables represent amounts due from manufacturers, including holdbacks, rebates, incentives and warranty claims.
- Auto loan receivables include amounts due from customers related to retail sales of vehicles and certain finance and insurance products.

Interest income on auto loan receivables is recognized based on the contractual terms of each loan and is accrued until repayment, charge-off or repossession. Direct costs associated with loan originations are capitalized and expensed as an offset to interest income when recognized on the loans. All other receivables are recorded at invoice and do not bear interest until they are 60 days past due.

The allowance for doubtful accounts is estimated based on our historical write-off experience and is reviewed monthly. Consideration is given to recent delinquency trends and recovery rates. Account balances are charged against the allowance after all appropriate means of collection have been exhausted and the potential for recovery is considered remote. The annual activity for charges and subsequent recoveries is immaterial.

The long-term portion of accounts receivable was included as a component of other non-current assets in the Consolidated Balance Sheets.

Note 3. Inventories

The components of inventories, net, consisted of the following (in thousands):

	September 30, 2016	**December 31, 2015**
New vehicles	$1,216,699	$1,113,613
Used vehicles	378,926	302,911
Parts and accessories	62,068	54,463
Total inventories	$1,657,693	$1,470,987

Note 4. Goodwill and Franchise Value

The changes in the carrying amounts of goodwill are as follows (in thousands):

	Domestic	**Import**	**Luxury**	**Consolidated**
Balance as of December 31, 2014 [1]	$91,011	$79,601	$28,763	$ 199,375
Additions through acquisitions	6,892	5,029	2,170	14,091
Reduction related to divestiture	—	(246)	—	(246)
Balance as of December 31, 2015 [1]	97,903	84,384	30,933	213,220
Additions through acquisitions [2]	3,447	2,895	677	7,019
Reduction related to divestiture	(1,218)	—	—	(1,218)
Balance as of September 30, 2016 [1]	$100,132	$87,279	$31,610	$ 219,021

[1] Net of accumulated impairment losses of $299.3 million recorded during the year ended December 31, 2008.

[2] Our purchase price allocation is preliminary for the acquisitions related to the Carbone Auto Group and Casper Ford and the associated goodwill has not been allocated to each of our segments. See also Note 12.

The changes in the carrying amounts of franchise value are as follows (in thousands):

	Franchise Value
Balance as of December 31, 2014	$ 150,892
Additions through acquisitions	6,843
Reduction related to divestiture	(36)
Balance as of December 31, 2015	157,699
Additions through acquisitions [1]	6,039
Reduction related to divestiture	(518)
Balance as of September 30, 2016	$ 163,220

[1] Our purchase price allocation is preliminary for the acquisitions related to the Carbone Auto Group and Casper Ford and have not been included in the above franchise value additions. See also Note 12.

<u>Note 5. Stockholders' Equity</u>

Repurchases of Class A Common Stock

Repurchases of our Class A Common Stock occurred under repurchase authorizations granted by our Board of Directors and related to shares withheld as part of the vesting of restricted stock units ("RSUs").

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In August 2011, our Board of Directors authorized the repurchase of up to 2 million shares of our Class A common stock and, on July 20, 2012, our Board of Directors authorized the repurchase of 1 million additional shares of our Class A common stock. Effective February 29, 2016, our Board of Directors authorized the repurchase of up to $250 million of our Class A common stock. This authorization replaced the existing authorizations, increasing the total and establishing a maximum dollar rather than share amount.

Share repurchases under our authorizations were as follows:

	Repurchases Occurring in the Nine Months Ended September 30, 2016		**Cumulative Repurchases as of September 30, 2016**	
	Shares	**Average Price**	**Shares**	**Average Price**
2011 Share Repurchase Authorization	599,123	$ 79.21	2,327,636	$ 51.09
2016 Share Repurchase Authorization	666,475	$ 78.90	666,475	$ 78.90

As of September 30, 2016, we had $197.4 million available for repurchases pursuant to our 2016 share repurchase authorization.

In addition, during the first nine months of 2016, we repurchased 94,725 shares at an average price of $90.46 per share, for a total of $8.6 million, related to tax withholdings associated with the vesting of RSUs. The repurchase of shares related to tax withholdings associated with stock awards does not reduce the number of shares available for repurchase as approved by our Board of Directors.

Class B Common Stock Conversion

On March 2, 2016, Lithia Holding Company, L.L.C. (“Holding Company”), which is managed and controlled by Sidney B. DeBoer, our Chairman of the Board, notified us that it had converted 780,000 shares of our Class B Common Stock into shares of our Class A Common Stock and distributed them to certain members of Holding Company in redemption of their membership interests in Holding Company. At that time, this transaction decreased the voting power of Holding Company to 42.4% from 52.3%, but did not result in any person acquiring voting control over us.

Dividends

Dividends paid on our Class A and Class B common stock were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	**2015**	**2016**	**2015**
Dividend amount per share	$0.25	$0.20	$0.70	$0.56
Total amount of dividend (in thousands)	6,299	5,257	17,823	14,739

See Note 14 for a discussion of a dividend related to our third quarter 2016 financial results.

Note 6. Deferred Compensation and Long-Term Incentive Plan

We offer a deferred compensation and long-term incentive plan (the "LTIP") to provide certain employees the ability to accumulate assets for retirement on a tax-deferred basis. We may make discretionary contributions to the LTIP. Discretionary contributions vest over a period of time up to seven years depending on the employee's age and position. Additionally, a participant may defer a portion of his or her compensation and receive the deferred amount upon certain events, including termination or retirement. The following is a summary related to our LTIP (dollars in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	**2015**	**2016**	**2015**
Compensation expense	$355	$450	$887	$1,369
Discretionary contribution	$393	$—	$1,785	$2,249
Guaranteed annual return	5.25%	5.25%	5.25 %	5.25 %

As of September 30, 2016 and December 31, 2015, the balance due, comprised of both amounts participants elected to defer and discretionary contributions, was $21.1 million and $19.7 million, respectively, and was included as a component of accrued liabilities and other long-term liabilities in the Consolidated Balance Sheets.

Assets to fund the obligations of the LTIP are held in a Rabbi Trust and must be used only for purposes of providing benefits under the plan, other than in an event of insolvency. The assets held by the Rabbi Trust are invested in corporate-owned life insurance. As of September 30, 2016 and December 31, 2015, the value of the assets held by the Rabbi trust were $21.1 million and $15.4 million, respectively, and are recorded as a component of other non-current assets in the Consolidated Balance Sheets.

Note 7. Fair Value Measurements

Factors used in determining the fair value of our financial assets and liabilities are summarized into three broad categories:

- Level 1 - quoted prices in active markets for identical securities;
- Level 2 - other significant observable inputs, including quoted prices for similar securities, interest rates, prepayment spreads, credit risk; and
- Level 3 - significant unobservable inputs, including our own assumptions in determining fair value.

The inputs or methodology used for valuing financial assets and liabilities are not necessarily an indication of the risk associated with investing in them.

We estimate the value of our equity-method investment, which is recorded at fair value on a non-recurring basis, based on a market valuation approach. We use prices and other relevant information generated primarily by recent market transactions involving similar or comparable assets. Because these valuations contain unobservable inputs, we classified the measurement of fair value of our equity-method investment as Level 3.

We estimate the value of other long-lived assets that are recorded at fair value on a non-recurring basis based on a market valuation approach. We use prices and other relevant information generated primarily by recent market transactions involving similar or comparable assets, as well as our historical experience in divestitures, acquisitions and real estate transactions. Additionally, we may use a cost valuation approach to value long-lived assets when a market valuation approach is unavailable. Under this approach, we determine the cost to replace the service capacity of an asset, adjusted for physical and economic obsolescence. When available, we use valuation inputs from independent valuation experts, such as real estate appraisers and brokers, to corroborate our estimates of fair value. Real estate appraisers' and brokers' valuations are typically developed using one or more valuation techniques including market, income and replacement cost approaches. Because these valuations contain unobservable inputs, we classified the measurement of fair value of long-lived assets as Level 3.

There were no changes to our valuation techniques during the nine-month period ended September 30, 2016.

Assets and Liabilities Measured at Fair Value

Following are the disclosures related to our assets and liabilities that are measured at fair value (in thousands):

Fair Value at September 30, 2016	**Level 1**	**Level 2**	**Level 3**
Measured on a non-recurring basis:			
Equity-method investment	$ —	$ —	$5,594

Fair Value at December 31, 2015	**Level 1**	**Level 2**	**Level 3**
Measured on a recurring basis:			
Derivative contract, net	$ —	$532	$ —