

LITHIA MOTORS INC
Form 10-Q
November 02, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2015

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 No

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

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

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

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 | 23,694,039 |
| Class B common stock without par value | 2,562,231 |
| (Class) | (Outstanding at October 30, 2015) |

LITHIA MOTORS, INC.

FORM 10-Q

INDEX

| <u>PART I - FINANCIAL INFORMATION</u> | | <u>Page</u> |
|---------------------------------------|---|-------------|
| Item 1. | Financial Statements | 2 |
| | Consolidated Balance Sheets (Unaudited) – September 30, 2015 and December 31, 2014 | 2 |
| | Consolidated Statements of Operations (Unaudited) – Three and Nine Months Ended September 30, 2015 and 2014 | 3 |
| | Consolidated Statements of Comprehensive Income (Unaudited) – Three and Nine Months Ended September 30, 2015 and 2014 | 4 |
| | Consolidated Statements of Cash Flows (Unaudited) – Nine Months Ended September 30, 2015 and 2014 | 5 |
| | Condensed Notes to Consolidated Financial Statements (Unaudited) | 6 |
| Item 2. | Management’s Discussion and Analysis of Financial Condition and Results of Operations | 23 |
| Item 3. | Quantitative and Qualitative Disclosures About Market Risk | 48 |
| Item 4. | Controls and Procedures | 49 |
| <u>PART II - OTHER INFORMATION</u> | | |
| Item 1A. | Risk Factors | 49 |
| Item 2. | Unregistered Sales of Equity Securities and Use of Proceeds | 50 |
| Item 6. | Exhibits | 50 |
| | Signatures | 51 |

LITHIA MOTORS, INC. AND SUBSIDIARIES**Consolidated Balance Sheets****(In thousands)****(Unaudited)**

| | September 30, 2015 | December 31, 2014 |
|--|-----------------------------------|----------------------------------|
| Assets | | |
| Current Assets: | | |
| Cash and cash equivalents | \$32,707 | \$29,898 |
| Accounts receivable, net of allowance for doubtful accounts of \$1,474 and \$2,191 | 285,730 | 295,379 |
| Inventories, net | 1,386,960 | 1,249,659 |
| Other current assets | 32,640 | 32,010 |
| Assets held for sale | - | 8,563 |
| Total Current Assets | 1,738,037 | 1,615,509 |
| Property and equipment, net of accumulated depreciation of \$135,365 and \$117,679 | 854,077 | 816,745 |
| Goodwill | 210,627 | 199,375 |
| Franchise value | 155,187 | 150,892 |
| Other non-current assets | 101,901 | 98,411 |
| Total Assets | \$3,059,829 | \$2,880,932 |
| Liabilities and Stockholders' Equity | | |
| Current Liabilities: | | |
| Floor plan notes payable | \$46,651 | \$41,047 |
| Floor plan notes payable: non-trade | 1,168,223 | 1,137,632 |
| Current maturities of long-term debt | 38,745 | 31,912 |
| Trade payables | 77,723 | 70,853 |
| Accrued liabilities | 167,135 | 153,661 |
| Deferred income taxes | 3,792 | 2,603 |
| Liabilities related to assets held for sale | - | 4,892 |
| Total Current Liabilities | 1,502,269 | 1,442,600 |
| Long-term debt, less current maturities | 591,231 | 609,066 |
| Deferred revenue | 63,238 | 54,403 |
| Deferred income taxes | 29,013 | 42,795 |
| Other long-term liabilities | 86,365 | 58,963 |
| Total Liabilities | 2,272,116 | 2,207,827 |
| Stockholders' Equity: | | |
| Preferred stock - no par value; authorized 15,000 shares; none outstanding | - | - |
| | 263,531 | 276,058 |

Edgar Filing: LITHIA MOTORS INC - Form 10-Q

| | | |
|--|-------------|-------------|
| Class A common stock - no par value; authorized 100,000 shares; issued and outstanding 23,742 and 23,671 | | |
| Class B common stock - no par value; authorized 25,000 shares; issued and outstanding 2,562 and 2,562 | 319 | 319 |
| Additional paid-in capital | 35,917 | 29,775 |
| Accumulated other comprehensive loss | (461) | (926) |
| Retained earnings | 488,407 | 367,879 |
| Total Stockholders' Equity | 787,713 | 673,105 |
| Total Liabilities and Stockholders' Equity | \$3,059,829 | \$2,880,932 |

See accompanying condensed notes to consolidated financial statements.

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, | |
|--|---|-------------|--|-------------|
| | 2015 | 2014 | 2015 | 2014 |
| Revenues: | | | | |
| New vehicle | \$1,227,080 | \$732,121 | \$3,384,408 | \$2,006,127 |
| Used vehicle retail | 505,885 | 340,522 | 1,457,617 | 952,890 |
| Used vehicle wholesale | 69,472 | 48,853 | 198,476 | 135,832 |
| Finance and insurance | 76,633 | 46,855 | 213,700 | 130,324 |
| Service, body and parts | 189,796 | 120,772 | 545,966 | 339,726 |
| Fleet and other | 15,979 | 7,988 | 70,803 | 32,120 |
| Total revenues | 2,084,845 | 1,297,111 | 5,870,970 | 3,597,019 |
| Cost of sales: | | | | |
| New vehicle | 1,149,923 | 684,473 | 3,176,135 | 1,873,461 |
| Used vehicle retail | 443,598 | 296,624 | 1,273,195 | 824,129 |
| Used vehicle wholesale | 68,892 | 48,349 | 194,329 | 132,493 |
| Service, body and parts | 95,846 | 62,351 | 276,828 | 174,291 |
| Fleet and other | 15,399 | 7,474 | 68,272 | 30,444 |
| Total cost of sales | 1,773,658 | 1,099,271 | 4,988,759 | 3,034,818 |
| Gross profit | 311,187 | 197,840 | 882,211 | 562,201 |
| Asset impairments | 4,131 | - | 14,391 | - |
| Selling, general and administrative | 223,728 | 131,627 | 610,956 | 378,919 |
| Depreciation and amortization | 10,531 | 6,067 | 30,544 | 17,399 |
| Operating income | 72,797 | 60,146 | 226,320 | 165,883 |
| Floor plan interest expense | (4,951) | (3,127) | (14,255) | (9,326) |
| Other interest expense | (4,900) | (2,051) | (14,700) | (5,894) |
| Other (expense) income, net | (307) | 1,027 | (1,031) | 3,110 |
| Income from continuing operations before income taxes | 62,639 | 55,995 | 196,334 | 153,773 |
| Income tax provision | (19,248) | (21,458) | (61,067) | (59,372) |
| Income from continuing operations, net of income tax | 43,391 | 34,537 | 135,267 | 94,401 |
| Income from discontinued operations, net of income tax | - | - | - | 3,179 |
| Net income | \$43,391 | \$34,537 | \$135,267 | \$97,580 |
| Basic income per share from continuing operations | \$1.65 | \$1.32 | \$5.14 | \$3.62 |
| Basic income per share from discontinued operations | - | - | - | 0.12 |
| Basic net income per share | \$1.65 | \$1.32 | \$5.14 | \$3.74 |
| Shares used in basic per share calculations | 26,289 | 26,118 | 26,304 | 26,071 |

Edgar Filing: LITHIA MOTORS INC - Form 10-Q

| | | | | |
|---|--------|--------|--------|--------|
| Diluted income per share from continuing operations | \$1.64 | \$1.31 | \$5.10 | \$3.58 |
| Diluted income per share from discontinued operations | - | - | - | 0.13 |
| Diluted net income per share | \$1.64 | \$1.31 | \$5.10 | \$3.71 |
| Shares used in diluted per share calculations | 26,480 | 26,359 | 26,500 | 26,337 |

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, | |
|---|---|-------------|--|-------------|
| | 2015 | 2014 | 2015 | 2014 |
| Net income | \$43,391 | \$34,537 | \$135,267 | \$97,580 |
| Other comprehensive income, net of tax: | | | | |
| Gain on cash flow hedges, net of tax expense of \$103, \$114, \$283, and \$288 respectively | 161 | 184 | 465 | 463 |
| Comprehensive income | \$43,552 | \$34,721 | \$135,732 | \$98,043 |

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, | |
|---|--|------------------|
| | 2015 | 2014 |
| Cash flows from operating activities: | | |
| Net income | \$ 135,267 | \$ 97,580 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Asset impairments | 14,391 | - |
| Depreciation and amortization | 30,544 | 17,399 |
| Stock-based compensation | 8,579 | 5,054 |
| Loss on disposal of other assets | 27 | 307 |
| Gain on disposal of franchise | (5,919) | (5,744) |
| Deferred income taxes | (7,955) | 4,725 |
| Excess tax benefit from share-based payment arrangements | (4,923) | (6,160) |
| (Increase) decrease (net of acquisitions and dispositions): | | |
| Trade receivables, net | 9,685 | (11,336) |
| Inventories | (132,407) | (44,349) |
| Other assets | (5,339) | (13,700) |
| Increase (decrease) (net of acquisitions and dispositions): | | |
| Floor plan notes payable | 5,604 | 1,132 |
| Trade payables | 7,768 | 4,246 |
| Accrued liabilities | 16,949 | 21,913 |
| Other long-term liabilities and deferred revenue | 34,651 | 16,635 |
| Net cash provided by operating activities | 106,922 | 87,702 |
| Cash flows from investing activities: | | |
| Principal payments received on notes receivable | - | 2,882 |
| Capital expenditures | (62,159) | (54,149) |
| Proceeds from sales of assets | 229 | 3,243 |
| Cash paid for other investments | (20,693) | (3,385) |
| Cash paid for acquisitions, net of cash acquired | (34,920) | (81,558) |
| Proceeds from sales of stores | 12,966 | 10,617 |
| Net cash used in investing activities | (104,577) | (122,350) |
| Cash flows from financing activities: | | |
| Borrowings on floor plan notes payable, net: non-trade | 36,204 | 30,375 |
| Borrowings on lines of credit | 878,340 | 836,156 |
| Repayments on lines of credit | (939,817) | (891,000) |
| Principal payments on long-term debt, scheduled | (11,048) | (5,528) |

Edgar Filing: LITHIA MOTORS INC - Form 10-Q

| | | |
|--|-----------------|-----------------|
| Principal payments on long-term debt and capital leases, other | (9,189) | - |
| Proceeds from issuance of long-term debt | 75,675 | 76,530 |
| Proceeds from issuance of common stock | 4,313 | 3,411 |
| Repurchase of common stock | (24,198) | (11,745) |
| Excess tax benefit from share-based payment arrangements | 4,923 | 6,160 |
| Dividends paid | (14,739) | (11,731) |
| Net cash provided by financing activities | 464 | 32,628 |
| | | |
| Increase (decrease) in cash and cash equivalents | 2,809 | (2,020) |
| | | |
| Cash and cash equivalents at beginning of period | 29,898 | 23,686 |
| Cash and cash equivalents at end of period | \$32,707 | \$21,666 |
| | | |
| Supplemental disclosure of cash flow information: | | |
| Cash paid during the period for interest | \$31,140 | \$15,556 |
| Cash paid during the period for income taxes, net | 50,917 | 44,918 |
| | | |
| Supplemental schedule of non-cash activities: | | |
| Debt issued in connection with acquisitions | \$2,160 | \$3,161 |
| Floor plan debt paid in connection with store disposals | 4,400 | 3,311 |

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, 2015 and for the three- and nine-month periods ended September 30, 2015 and 2014. 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 2014 audited Consolidated Financial Statements and the related notes thereto. The financial information as of December 31, 2014 is derived from our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 2, 2015. The interim condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and the notes thereto included in our 2014 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 prior period amounts have been reclassified to conform to the current presentation of our financial information. This reclassification was limited to our definition of segment income, which is currently income from continuing operations before taxes less depreciation and amortization, other interest expense and other (expense) income, net. Specifically, we defined intercompany charges and no longer include depreciation and amortization, other interest expense and other (expense) income, net as a component of segment income. These reclassifications had no effect on previously reported net income.

Note 2. Accounts Receivable

Accounts receivable consisted of the following (in thousands):

| September | December |
|------------------|-----------------|
| 30, | 31, |

Edgar Filing: LITHIA MOTORS INC - Form 10-Q

| | 2015 | 2014 |
|---|-------------|-------------|
| Contracts in transit | \$ 147,729 | \$ 162,785 |
| Trade receivables | 33,567 | 37,194 |
| Vehicle receivables | 33,429 | 34,876 |
| Manufacturer receivables | 61,144 | 56,008 |
| Auto loan receivables | 34,943 | 25,424 |
| Other receivables | 4,494 | 4,554 |
| | 315,306 | 320,841 |
| Less: Allowances | (2,701) | (3,130) |
| Less: Long-term portion of accounts receivable, net | (26,875) | (22,332) |
| Total accounts receivable, net | \$ 285,730 | \$ 295,379 |

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 within five to ten days of selling a vehicle.

Trade receivables are comprised of amounts due from customers, 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, net, 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, | December 31, |
|-----------------------|--------------------------|-------------------------|
| | 2015 | 2014 |
| New vehicles | \$1,036,022 | \$958,876 |
| Used vehicles | 298,954 | 240,908 |
| Parts and accessories | 51,984 | 49,875 |
| Total inventories | \$1,386,960 | \$1,249,659 |

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, 2013⁽¹⁾ | \$ 22,548 | \$ 16,797 | \$ 10,166 | \$ 49,511 |
| Additions through acquisitions | 68,463 | 62,804 | 18,597 | 149,864 |
| Balance as of December 31, 2014⁽¹⁾ | 91,011 | 79,601 | 28,763 | 199,375 |
| Additions through acquisitions | 5,825 | 3,870 | 1,803 | 11,498 |
| Reduction related to divestiture | - | (246) | - | (246) |
| Balance as of September 30, 2015⁽¹⁾ | \$ 96,836 | \$ 83,225 | \$ 30,566 | \$ 210,627 |

(1) Net of accumulated impairment losses of \$299.3 million recorded during the year ended December 31, 2008.

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

| | Franchise Value |
|---|----------------------------|
| Balance as of December 31, 2013 | \$ 71,199 |
| Additions through acquisitions | 80,233 |
| Transfers to assets held for sale | (540) |
| Balance as of December 31, 2014 | 150,892 |
| Additions through acquisitions | 4,331 |
| Reduction related to divestiture | (36) |
| Balance as of September 30, 2015 | \$ 155,187 |

Note 5. Stockholders' Equity

Reclassification From Accumulated Other Comprehensive Loss

The reclassification from accumulated other comprehensive loss was as follows (in thousands):

| | Three Months Ended September 30, 2015 2014 | | Affected Line Item in the Consolidated Statements of Operations |
|-------------------------------|---|---------|--|
| Loss on cash flow hedges | \$(104) | \$(119) | Floor plan interest expense |
| Taxes | 40 | 46 | Income tax provision |
| Loss on cash flow hedges, net | \$(64) | \$(73) | |

| | Nine Months Ended September 30, 2015 2014 | | Affected Line Item in the Consolidated Statements of Operations |
|-------------------------------|--|---------|--|
| Loss on cash flow hedges | \$(336) | \$(370) | Floor plan interest expense |
| Taxes | 131 | 141 | Income tax provision |
| Loss on cash flow hedges, net | \$(205) | \$(229) | |

See Note 8 for more details regarding our derivative contracts.

Repurchases of Class A Common Stock

In August 2011, our Board of Directors authorized the repurchase of up to 2,000,000 shares of our Class A common stock and, on July 20, 2012, our Board of Directors authorized the repurchase of 1,000,000 additional shares of our Class A common stock. Through September 30, 2015, we have repurchased 1,664,613 shares under this program at an average price of \$38.51 per share. Of this amount, 164,837 shares were repurchased during the first nine months of 2015 at an average price of \$105.15 per share for a total of \$17.3 million. As of September 30, 2015, 1,335,387 shares remained available for repurchase pursuant to this program. The authority to repurchase does not have an expiration date.

In addition, during the first nine months of 2015, we repurchased 77,596 shares at an average price of \$88.48 per share, for a total of \$6.9 million, related to tax withholdings associated with the vesting of restricted stock units (“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.

Dividends

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

| | Three Months Ended | | Nine Months Ended | |
|---|-------------------------------|-------------|------------------------------|-------------|
| | September 30, | | September 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| Dividend amount per share | \$0.20 | \$0.16 | \$0.56 | \$0.45 |
| Total amount of dividend (in thousands) | 5,257 | 4,174 | 14,739 | 11,731 |

See Note 16 for a discussion of a dividend related to our third quarter 2015 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 one 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 | | Nine Months Ended | |
|----------------------------|-------------------------------|-------------|------------------------------|-------------|
| | September 30, | | September 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| Compensation expense | \$450 | \$381 | \$1,369 | \$1,458 |
| Discretionary contribution | - | 350 | 2,249 | 2,450 |
| Guaranteed annual return | 5.25% | 5.25% | 5.25% | 5.25% |

As of September 30, 2015 and December 31, 2014, the balance due to participants was \$17.7 million and \$14.2 million, respectively, and was included as a component of accrued liabilities and other long-term liabilities 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 use the income approach to determine the fair value of our interest rate swap using observable Level 2 market expectations at each measurement date and an income approach to convert estimated future cash flows to a single present value amount (discounted) assuming that participants are motivated, but not compelled, to transact. Level 2 inputs for the swap valuation are limited to quoted prices for similar assets or liabilities in active markets (specifically futures contracts on LIBOR for the first two years) and inputs other than quoted prices that are observable for the asset or liability (specifically LIBOR cash and swap rates and credit risk at commonly quoted intervals). Mid-market pricing is used as a practical expedient for fair value measurements. Key inputs, including the cash rates for very short term borrowings, futures rates for up to two years and LIBOR swap rates beyond the derivative maturity, are used to predict future reset rates to discount those future cash flows to present value at the measurement date.

Inputs are collected from Bloomberg on the last market day of the period and used to determine the rate applied to discount the future cash flows. The valuation of the interest rate swap also takes into consideration estimates of our own, as well as the counterparty's, risk of non-performance under the contract. See Note 8 for more details regarding our derivative contracts.

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 long-lived assets that are recorded at fair value 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, 2015.

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, 2015 | Level 1 | Level 2 | Level 3 |
|---|--------------------|--------------------|----------------|
| Measured on a recurring basis: | | | |
| Derivative contracts, net | \$ - | \$(877) | \$- |
| Measured on a non-recurring basis: | | | |
| Equity-method investment | \$ - | \$- | \$28,147 |
| Long-lived assets held and used: | | | |
| Certain buildings and improvements | - | - | 3,367 |

| Fair Value at December 31, 2014 | Level 1 | Level 2 | Level 3 |
|---|--------------------|----------------|----------------|
| Measured on a recurring basis: | | | |
| Derivative contracts, net | \$ - | \$(1,750) | \$- |
| Measured on a non-recurring basis: | | | |
| Equity-method investment | \$ - | \$- | \$33,282 |

See Note 8 for more details regarding our derivative contracts.

Based on operating losses recognized by the equity-method investment, we determined that an impairment of our investment had occurred. Accordingly, we performed a fair value calculation for this investment and determined that a \$4.1 million and an \$12.4 million impairment, respectively, was required to be recorded as asset impairments in our Consolidated Statements of Operations for the three and nine months ended September 30, 2015. See Note 12.

Long-lived assets classified as held and used are reviewed for impairment whenever events or circumstances indicate that the carrying amount of the assets may not be recoverable. An estimate of future undiscounted net cash flows associated with the long-lived assets is used to determine if the carrying value of the assets is recoverable. An impairment charge is recorded if the carrying value of the asset is determined to not be recoverable and exceeds its fair value. Due to changes in the expected future use for certain properties, during the second quarter of 2015, we evaluated the future undiscounted net cash flows for each property. We determined the carrying value was not recoverable and exceeded the estimated fair value. As a result of this evaluation, we recorded \$2.0 million of impairment charges associated with these properties in the second quarter of 2015.

Fair Value Disclosures for Financial Assets and Liabilities

We determined the carrying value of cash equivalents, accounts receivable, trade payables, accrued liabilities and short-term borrowings approximate their fair values because of the nature of their terms and current market rates of these instruments. We believe the carrying value of our variable rate debt approximates fair value.

We have fixed rate debt and calculate the estimated fair value of our fixed rate debt using a discounted cash flow methodology. Using estimated current interest rates based on a similar risk profile and duration (Level 2), the fixed cash flows are discounted and summed to compute the fair value of the debt. As of September 30, 2015, this debt had maturity dates between November 2016 and October 2034. A summary of the aggregate carrying values and fair values of our long-term fixed interest rate debt is as follows (in thousands):

| | September 30, 2015 | December 31, 2014 |
|----------------|-----------------------------------|----------------------------------|
| Carrying value | \$ 248,557 | \$ 257,780 |
| Fair value | 256,881 | 270,781 |

Note 8. Derivative Financial Instrument

From time to time, we enter into interest rate swaps to fix a portion of our interest expense. We do not enter into derivative instruments for any purpose other than to manage interest rate exposure to fluctuations in the one-month LIBOR benchmark. That is, we do not engage in interest rate speculation using derivative instruments.

As of September 30, 2015, we had a \$25 million interest rate swap outstanding with U.S. Bank Dealer Commercial Services. This interest rate swap matures on June 15, 2016 and has a fixed rate of 5.587% per annum. The variable rate on the interest rate swap is the one-month LIBOR rate. At September 30, 2015, the one-month LIBOR rate was 0.20% per annum, as reported in the Wall Street Journal.

Typically, we designate all interest rate swaps as cash flow hedges and, accordingly, we record the change in fair value for the effective portion of these interest rate swaps in comprehensive income rather than net income until the underlying hedged transaction affects net income. If a swap is no longer designated as a cash flow hedge and the forecasted transaction remains probable or reasonably possible of occurring, the gain or loss recorded in accumulated other comprehensive loss is recognized in income as the forecasted transaction occurs. If the forecasted transaction is probable of not occurring, the gain or loss recorded in accumulated other comprehensive loss is recognized in income immediately. See Note 7.

The estimated amount that we expect to reclassify from accumulated other comprehensive loss to net income within the next twelve months is \$0.8 million at September 30, 2015.

The fair value of our derivative instruments was included in our Consolidated Balance Sheets as follows (in thousands):

| Balance Sheet Information | | Fair Value of Liability Derivatives | |
|----------------------------------|-----------------------------|--|-----|
| Derivatives Designated as | | September 30, | |
| Hedging Instruments | | Location in Balance Sheet | |
| | | 2015 | |
| Interest Rate Swap Contract | Accrued liabilities | \$ | 877 |
| | Other long-term liabilities | | - |
| | | \$ | 877 |

| Balance Sheet Information | | Fair Value of Liability Derivatives | |
|----------------------------------|-----------------------------|--|-------|
| Derivatives Designated as | | December 31, | |
| Hedging Instruments | | Location in Balance Sheet | |
| | | 2014 | |
| Interest Rate Swap Contract | Accrued liabilities | \$ | 1,194 |
| | Other long-term liabilities | | 556 |
| | | \$ | 1,750 |

The effect of derivative instruments on our Consolidated Statements of Operations was as follows (in thousands):

| Derivatives in Cash Flow Hedging Relationships | Amount of Gain Recognized in Accumulated OCI (Effective Portion) | Location of Loss Reclassified from Accumulated OCI into Income (Effective Portion) | Amount of Loss Reclassified from Accumulated OCI into Income (Effective Portion) | Location of Loss Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing) | Amount of Loss Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing) |
|---|---|---|---|---|---|
| | | | | | |
| Three Months Ended September 30, 2015 | | | | | |
| Interest Rate Swap Contract | \$ 160 | Floor plan interest expense | \$ (104) | Floor plan interest expense | \$ (195) |

Edgar Filing: LITHIA MOTORS INC - Form 10-Q

| | | | | | |
|--|--------|------------------|-----------|------------------|-----------|
| Three Months Ended September 30, 2014 | | Floor plan | | Floor plan | |
| Interest Rate Swap Contract | \$ 179 | interest expense | \$ (119) | interest expense | \$ (184) |

| Derivatives in Cash Flow Hedging Relationships | Amount of Gain Recognized in Accumulated OCI (Effective Portion) | Location of Loss Reclassified from Accumulated OCI into Income (Effective Portion) | Amount of Loss Reclassified from Accumulated OCI into Income (Effective Portion) | Location of Loss Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing) | Amount of Loss Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing) |
|---|---|---|---|---|---|
| | | | | | |

| | | | | | |
|---|--------|------------------|-----------|------------------|-----------|
| Nine Months Ended September 30, 2015 | | Floor plan | | Floor plan | |
| Interest Rate Swap Contract | \$ 412 | interest expense | \$ (336) | interest expense | \$ (563) |

| | | | | | |
|---|--------|------------------|-----------|------------------|-----------|
| Nine Months Ended September 30, 2014 | | Floor plan | | Floor plan | |
| Interest Rate Swap Contract | \$ 381 | interest expense | \$ (370) | interest expense | \$ (543) |

See also Note 7.

Note 9. Acquisitions

In the first nine months of 2015, we completed the following acquisitions, which contributed revenues of \$10.5 million for the nine months ended September 30, 2015:

On May 14, 2015, we acquired a smart franchise from Smart Center of Omaha.

On July 31, 2015, we acquired Bitterroot Ford in Missoula, Montana.

On August 20, 2015, we acquired Acura of Honolulu in Honolulu, Hawaii.

On September 28, 2015, we acquired Bennett Motors in Great Falls, Montana.

All acquisitions were accounted for as business combinations under the acquisition method of accounting. The results of operations of the acquired stores are included in our Consolidated Financial Statements from the date of acquisition.

No portion of the purchase price was paid with our equity securities. The following table summarizes the consideration paid for the acquisitions and the amount of identified assets acquired and liabilities assumed as of the acquisition date (in thousands):

| | Consideration |
|---------------------------------|----------------------|
| Cash paid, net of cash acquired | \$ 34,920 |
| Debt issued | 2,160 |
| | \$ 37,080 |

| | Assets Acquired and Liabilities Assumed |
|-------------------------------|--|
| Inventories | \$ 12,551 |
| Franchise value | 4,331 |
| Property, plant and equipment | 10,990 |
| Other assets | 178 |
| Other liabilities | (2,468) |
| | 25,582 |
| Goodwill | 11,498 |
| | \$ 37,080 |

We account for franchise value as an indefinite-lived intangible asset. We expect the full amount of the goodwill recognized to be deductible for tax purposes.

The following unaudited pro forma summary presents consolidated information as if all acquisitions in the three- and nine-month periods ended September 30, 2015 and 2014 had occurred on January 1, 2014 (in thousands, except for per share amounts):

| Three Months Ended September 30, | 2015 | 2014 |
|---|-------------|-------------|
| Revenue | \$2,102,459 | \$1,424,809 |
| Income from continuing operations, net of tax | 43,293 | 35,672 |
| Basic income per share from continuing operations, net of tax | 1.65 | 1.37 |
| Diluted income per share from continuing operations, net of tax | 1.63 | 1.35 |

| Nine Months Ended September 30, | 2015 | 2014 |
|---|-------------|-------------|
| Revenue | \$5,936,256 | \$3,991,066 |
| Income from continuing operations, net of tax | 134,738 | 97,903 |
| Basic income per share from continuing operations, net of tax | 5.12 | 3.76 |
| Diluted income per share from continuing operations, net of tax | 5.08 | 3.72 |

These amounts have been calculated by applying our accounting policies and estimates. The results of the acquired stores have been adjusted to reflect the following: depreciation on a straight-line basis over the expected lives for property, plant and equipment; accounting for inventory on a specific identification method; and recognition of interest expense for real estate financing related to stores where we purchased the facility. No nonrecurring pro forma adjustments directly attributable to the acquisitions are included in the reported pro forma revenues and earnings.

Note 10. Assets Held for Sale and Discontinued Operations***Assets Held for Sale***

We classify an asset group as held for sale if we have ceased operations at that location or the store meets the criteria required by U.S. generally accepted accounting standards as follows:

our management team, possessing the necessary authority, commits to a plan to sell the store;
 the store is available for immediate sale in its present condition;
 an active program to locate buyers and other actions that are required to sell the store are initiated;
 a market for the store exists and we believe its sale is likely within one year;
 active marketing of the store commences at a price that is reasonable in relation to the estimated fair market value;
 and
 our management team believes it is unlikely changes will be made to the plan or the plan to dispose of the store will be withdrawn.

As of December 31, 2014, we had two Import stores classified as held for sale. During the first nine months of 2015, we completed the sale of both of these Import stores, and recognized a gain of \$5.9 million as a component of selling, general and administrative in our Consolidated Statements of Operations for the nine months ended September 30, 2015.

As of September 30, 2015, we no longer had any stores classified as held for sale. Assets held for sale included the following (in thousands):

| | September 30, | December 31, |
|-------------------------------|--------------------------|-------------------------|
| | 2015 | 2014 |
| Inventories | \$ - | \$ 6,284 |
| Property, plant and equipment | - | 1,739 |
| Intangible assets | - | 540 |
| | \$ - | \$ 8,563 |

Liabilities related to assets held for sale included the following (in thousands):

| | September 30, | December 31, |
|--------------------------|--------------------------|-------------------------|
| | 2015 | 2014 |
| Floor plan notes payable | \$ - | \$ 4,892 |

Discontinued Operations and the Sales of Stores

In the third quarter of 2014, we early-adopted guidance that redefined discontinued operations. As a result, we determined that individual stores which met the criteria for held for sale after our adoption date would no longer qualify for classification as discontinued operations. We had previously reclassified a store's operations to discontinued operations in our Consolidated Statements of Operations, on a comparable basis for all periods presented, provided we did not expect to have any significant continuing involvement in the store's operations after its disposal.

Certain financial information related to discontinued operations and sales of stores was as follows (in thousands):

| | Three Months Ended September 30, 2015 | | Nine Months Ended September 30, 2014 | |
|--|--|------|---|----------|
| Revenue | \$ - | \$ - | \$- | \$12,569 |
| Pre-tax loss from discontinued operations | \$ - | \$ - | \$- | \$(467) |
| Net gain on disposal activities | - | - | - | 5,744 |
| | - | - | - | 5,277 |
| Income tax expense | - | - | - | (2,098) |
| Income from discontinued operations, net of income tax expense | \$ - | \$ - | \$- | \$3,179 |
| Goodwill and other intangible assets disposed of | \$ - | \$ - | \$282 | \$221 |
| Cash generated from disposal activities | - | - | 12,966 | 10,617 |
| Floor plan debt paid in connection with disposal activities | - | - | 4,400 | 3,311 |

Note 11. Net Income Per Share of Class A and Class B Common Stock

We compute net income per share of Class A and Class B common stock using the two-class method. Under this method, basic net income per share is computed using the weighted average number of common shares outstanding during the period excluding unvested common shares subject to repurchase or cancellation. Diluted net income per share is computed using the weighted average number of common shares and, if dilutive, potential common shares outstanding during the period. Potential common shares consist of the common shares issuable upon the net exercise of stock options and vested restricted stock units and is reflected in diluted earnings per share by application of the treasury stock method. The computation of the diluted net income per share of Class A common stock assumes the conversion of Class B common stock, while the diluted net income per share of Class B common stock does not assume the conversion of those shares.

Except with respect to voting and transfer rights, the rights of the holders of our Class A and Class B common stock are identical. Under our Articles of Incorporation, the Class A and Class B common stock share equally in any dividends, liquidation proceeds or other distribution with respect to our common stock and the Articles of Incorporation can only be amended by a vote of the shareholders. Additionally, Oregon law provides that amendments to our Articles of Incorporation that would adversely alter the rights, powers or preferences of a given class of stock, must be approved by the class of stock adversely affected by the proposed amendment. As a result, the undistributed earnings for each year are allocated based on the contractual participation rights of the Class A and Class B common shares as if the earnings for the year had been distributed. Because the liquidation and dividend rights are identical, the undistributed earnings are allocated on a proportionate basis.

Following is a reconciliation of the income from continuing operations and weighted average shares used for our basic earnings per share (“EPS”) and diluted EPS (in thousands, except per share amounts):

| Three Months Ended September 30, | 2015 | | 2014 | |
|--|----------------|----------------|----------------|----------------|
| Basic EPS from Continuing Operations | Class A | Class B | Class A | Class B |
| <i>Numerator:</i> | | | | |
| Income from continuing operations applicable to common stockholders | \$39,162 | \$4,229 | \$31,149 | \$3,388 |
| Distributed income applicable to common stockholders | (4,745) | (512) | (3,765) | (409) |
| Basic undistributed income from continuing operations applicable to common stockholders | \$34,417 | \$3,717 | \$27,384 | \$2,979 |
| <i>Denominator:</i> | | | | |
| Weighted average number of shares outstanding used to calculate basic income per share | 23,727 | 2,562 | 23,556 | 2,562 |
| Basic income per share from continuing operations applicable to common stockholders | \$1.65 | \$1.65 | \$1.32 | \$1.32 |
| Basic distributed income per share from continuing operations applicable to common stockholders | (0.20) | (0.20) | (0.16) | (0.16) |
| Basic undistributed income per share from continuing operations applicable to common stockholders | \$1.45 | \$1.45 | \$1.16 | \$1.16 |
| | | | | |
| Three Months Ended September 30, | 2015 | | 2014 | |
| Diluted EPS from Continuing Operations | Class A | Class B | Class A | Class B |
| <i>Numerator:</i> | | | | |
| Distributed income applicable to common stockholders | \$4,745 | \$512 | \$3,765 | \$409 |
| Reallocation of distributed income as a result of conversion of dilutive stock options | 3 | (3) | 3 | (3) |
| Reallocation of distributed income due to conversion of Class B to Class A common shares outstanding | 509 | - | 406 | - |
| Diluted distributed income applicable to common stockholders | \$5,257 | \$509 | \$4,174 | \$406 |
| Undistributed income from continuing operations applicable to common stockholders | \$34,417 | \$3,717 | \$27,384 | \$2,979 |
| Reallocation of undistributed income as a result of conversion of dilutive stock options | 27 | (27) | 28 | (28) |
| Reallocation of undistributed income due to conversion of Class B to Class A | 3,690 | - | 2,951 | - |
| Diluted undistributed income from continuing operations applicable to common stockholders | \$38,134 | \$3,690 | \$30,363 | \$2,951 |

Denominator:

| | | | | |
|---|---------|---------|---------|---------|
| Weighted average number of shares outstanding used to calculate basic income per share from continuing operations | 23,727 | 2,562 | 23,556 | 2,562 |
| Weighted average number of shares from stock options | 191 | - | 241 | - |
| Conversion of Class B to Class A common shares outstanding | 2,562 | - | 2,562 | - |
| Weighted average number of shares outstanding used to calculate diluted income per share from continuing operations | 26,480 | 2,562 | 26,359 | 2,562 |
| Diluted income per share from continuing operations applicable to common stockholders | \$1.64 | \$1.64 | \$1.31 | \$1.31 |
| Diluted distributed income per share from continuing operations applicable to common stockholders | (0.20) | (0.20) | (0.16) | (0.16) |
| Diluted undistributed income per share from continuing operations applicable to common stockholders | \$1.44 | \$1.44 | \$1.15 | \$1.15 |

Three Months Ended September 30,**Diluted EPS****Antidilutive Securities**

| | 2015 | | 2014 | |
|---|---------|---------|---------|---------|
| | Class A | Class B | Class A | Class B |
| Shares issuable pursuant to stock options not included since they were antidilutive | 18 | - | 13 | - |

Nine Months Ended September 30,**Basic EPS from Continuing Operations****Numerator:**

| | 2015 | | 2014 | |
|---|-----------|----------|-----------|----------|
| | Class A | Class B | Class A | Class B |
| Income from continuing operations applicable to common stockholders | \$122,092 | \$13,175 | \$85,124 | \$9,277 |
| Distributed income applicable to common stockholders | (13,303) | (1,436) | (10,578) | (1,153) |
| Basic undistributed income from continuing operations applicable to common stockholders | \$108,789 | \$11,739 | \$74,546 | \$8,124 |

Denominator:

| | | | | |
|---|---------|---------|---------|---------|
| Weighted average number of shares outstanding used to calculate basic income per share | 23,742 | 2,562 | 23,509 | 2,562 |
| Basic income per share from continuing operations applicable to common stockholders | \$5.14 | \$5.14 | \$3.62 | \$3.62 |
| Basic distributed income per share from continuing operations applicable to common stockholders | (0.56) | (0.56) | (0.45) | (0.45) |
| Basic undistributed income per share from continuing operations applicable to common stockholders | \$4.58 | \$4.58 | \$3.17 | \$3.17 |

| Nine Months Ended September 30, | 2015 | | 2014 | |
|---|-----------|----------|----------|---------|
| | Class A | Class B | Class A | Class B |
| Diluted EPS from Continuing Operations | | | | |
| <i>Numerator:</i> | | | | |
| Distributed income applicable to common stockholders | \$13,303 | \$1,436 | \$10,578 | \$1,153 |
| Reallocation of distributed income as a result of conversion of dilutive stock options | 11 | (11) | 12 | (12) |
| Reallocation of distributed income due to conversion of Class B to Class A common shares outstanding | 1,425 | - | 1,141 | - |
| Diluted distributed income applicable to common stockholders | \$14,739 | \$1,425 | \$11,731 | \$1,141 |
| Undistributed income from continuing operations applicable to common stockholders | \$108,789 | \$11,739 | \$74,546 | \$8,124 |
| Reallocation of undistributed income as a result of conversion of dilutive stock options | 86 | (86) | 82 | (82) |
| Reallocation of undistributed income due to conversion of Class B to Class A | 11,653 | - | 8,042 | - |
| Diluted undistributed income from continuing operations applicable to common stockholders | \$120,528 | \$11,653 | \$82,670 | \$8,042 |
| <i>Denominator:</i> | | | | |
| Weighted average number of shares outstanding used to calculate basic income per share from continuing operations | 23,742 | 2,562 | 23,509 | 2,562 |
| Weighted average number of shares from stock options | 196 | - | 266 | - |
| Conversion of Class B to Class A common shares outstanding | 2,562 | - | 2,562 | - |
| Weighted average number of shares outstanding used to calculate diluted income per share from continuing operations | 26,500 | 2,562 | 26,337 | 2,562 |
| Diluted income per share from continuing operations applicable to common stockholders | \$5.10 | \$5.10 | \$3.58 | \$3.58 |
| Diluted distributed income per share from continuing operations applicable to common stockholders | (0.56) | (0.56) | (0.45) | (0.45) |
| Diluted undistributed income per share from continuing operations applicable to common stockholders | \$4.54 | \$4.54 | \$3.13 | \$3.13 |

| Nine Months Ended September 30, | 2015 | | 2014 | |
|---|---------|---------|---------|---------|
| | Class A | Class B | Class A | Class B |
| Diluted EPS | | | | |
| <i>Antidilutive Securities</i> | | | | |
| Shares issuable pursuant to stock options not included since they were antidilutive | 17 | - | 13 | - |

Note 12. Equity-Method Investment

In October 2014, we acquired a 99.9% membership interest in a limited liability company managed by U.S. Bancorp Community Development Corporation with an initial equity contribution of \$4.1 million. We made additional equity contributions to the entity of \$5.7 million and \$17.1 million, respectively, in the three and nine-month periods ended September 30, 2015. We are obligated to make \$49.8 million of contributions to the entity over a two-year period ending October 2016, \$21.2 million of which had been paid as of September 30, 2015.

This investment generates new markets tax credits under the New Markets Tax Credit Program (“NMTC Program”). The NMTC Program was established by Congress in 2000 to spur new or increased investments into operating businesses and real estate projects located in low-income communities.

While U.S. Bancorp Community Development Corporation exercises management control over the limited liability company, due to the economic interest we hold in the entity, we determined our ownership portion of the entity was appropriately accounted for using the equity method.

The following amounts related to this equity-method investment were recorded in our Consolidated Balance Sheets (in thousands):

| | September 30, 2015 | December 31, 2014 |
|---|-----------------------------------|----------------------------------|
| Carrying value, recorded as a component of other non-current assets | \$ 28,147 | \$ 33,282 |
| Present value of obligation associated with future equity contributions, recorded as a component of accrued liabilities and other long-term liabilities | 28,061 | 32,177 |

The following amounts related to this equity-method investment were recorded in our Consolidated Statements of Operations (in thousands):

| | Three Months Ended | September 30, 2015 | September 30, 2014 | Nine Months Ended | September 30, 2015 | September 30, 2014 |
|--|-----------------------------------|-----------------------------------|-------------------------------|------------------------------|-------------------------------|-------------------------------|
| | | | | | | |

| | | | | |
|---|---------|------|----------|------|
| Asset impairments to write investment down to fair value | \$4,131 | \$ - | \$12,391 | \$ - |
| Our portion of the partnership's operating losses | 1,731 | - | 5,196 | - |
| Non-cash interest expense related to the amortization of the discounted fair value of future equity contributions | 155 | - | 549 | - |
| Tax benefits and credits generated | 7,414 | - | 22,316 | - |

Note 13. Transition Agreement

In September 2015, we entered into a Transition Agreement with Sidney B. DeBoer, our Executive Chairman, which provides him certain benefits for his prior service to us. These benefits will be in place until his death, irrespective of his future employment status. The Transition Agreement has an effective date of January 1, 2016 with the initial with payment of these benefits beginning in the third quarter of 2016.

We recorded a charge of \$18.3 million in the three and nine-month periods ended September 30, 2015 as a component of selling, general and administrative expense in our Consolidated Statement of Operations related to the present value of estimated future payments due pursuant to this agreement. We believe that these estimates are reasonable; however, actual cash flows could differ materially. We will periodically evaluate whether significant changes in these assumptions have occurred and record a charge if future expected cash flows are significantly different than the reserve recorded.

As of September 30, 2015 the balance associated with this agreement was \$18.3 million and was included as a component of accrued liabilities and other long-term liabilities in our Consolidated Balance Sheets.

Note 14. Segments

While we have determined that each individual store is an operating segment, we have aggregated our operating segments into three reportable segments based on their economic similarities: Domestic, Import and Luxury.

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

Corporate and other revenue and income includes the results of operations of our stand-alone collision center offset by unallocated corporate overhead expenses, such as corporate personnel costs, and certain unallocated reserve and elimination adjustments. Additionally, certain internal corporate expense allocations increase segment income for Corporate and other while decreasing segment income for the other reportable segments. These internal corporate expense allocations are used to increase comparability of our dealerships and reflect the capital burden a stand-alone dealership would experience. Examples of these internal allocations include internal rent expense, internal floor plan financing charges, and internal fees charged to offset employees within our corporate headquarters that perform certain dealership functions.

We define our chief operating decision maker (“CODM”) to be certain members of our executive management group. Historical and forecasted operational performance is evaluated on a store-by-store basis and on a consolidated basis by the CODM. We derive the operating results of the segments directly from our internal management reporting system. The accounting policies used to derive segment results are substantially the same as those used to determine our consolidated results, excepted for the internal allocation within Corporate and other discussed above. Our CODM measures the performance of each operating segment based on several metrics, including earnings from operations, and uses these results, in part, to evaluate the performance of, and to allocate resources to, each of the operating segments.

Certain financial information on a segment basis is as follows (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|---|-----------------------|-------------|-----------------------|-------------|
| | September 30, 2015 | 2014 | September 30, 2015 | 2014 |
| Revenues: | | | | |
| Domestic | \$814,155 | \$684,835 | \$2,272,914 | \$1,893,014 |
| Import | 893,465 | 412,136 | 2,507,181 | 1,160,250 |
| Luxury | 374,390 | 196,646 | 1,083,680 | 541,082 |
| | 2,082,010 | 1,293,617 | 5,863,775 | 3,594,346 |
| Corporate and other | 2,835 | 3,494 | 7,195 | 2,673 |
| | \$2,084,845 | \$1,297,111 | \$5,870,970 | \$3,597,019 |
| Segment income*: | | | | |
| Domestic | \$33,176 | \$26,659 | \$91,691 | \$74,528 |
| Import | 30,506 | 13,407 | 73,963 | 37,351 |
| Luxury | 8,140 | 6,227 | 25,360 | 14,246 |
| | 71,822 | 46,293 | 191,014 | 126,125 |
| Corporate and other | 6,555 | 16,793 | 51,595 | 47,831 |
| Depreciation and amortization | (10,531) | (6,067) | (30,544) | (17,399) |
| Other interest expense | (4,900) | (2,051) | (14,700) | (5,894) |
| Other (expense) income, net | (307) | 1,027 | (1,031) | 3,110 |
| Income from continuing operations before income taxes | \$62,639 | \$55,995 | \$196,334 | \$153,773 |

*Segment income for each of the segments is defined as Income from continuing operations before income taxes, depreciation and amortization, other interest expense and other (expense) income, net.

Floor plan interest expense:

| | | | | |
|---------------------|----------|----------|-----------|-----------|
| Domestic | \$5,441 | \$4,601 | \$15,083 | \$13,043 |
| Import | 3,779 | 1,966 | 11,227 | 5,698 |
| Luxury | 2,345 | 1,062 | 6,715 | 3,227 |
| | 11,565 | 7,629 | 33,025 | 21,968 |
| Corporate and other | (6,614) | (4,502) | (18,770) | (12,642) |
| | \$4,951 | \$3,127 | \$14,255 | \$9,326 |

| | September 30, 2015 | December 31, 2014 |
|----------------------|--------------------------|-------------------------|
| Total assets: | | |
| Domestic | \$961,582 | \$829,721 |

| | | |
|---------------------|-------------|-------------|
| Import | 700,042 | 698,015 |
| Luxury | 431,577 | 405,222 |
| Corporate and other | 966,628 | 947,974 |
| | \$3,059,829 | \$2,880,932 |

Note 15. Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued accounting standards update (“ASU”) 2014-09, “Revenue from Contracts with Customers,” which amends the accounting guidance related to revenues. This amendment will replace most of the existing revenue recognition guidance when it becomes effective. The new standard, as amended in July 2015, is effective for fiscal years beginning after December 15, 2017 and entities are allowed to adopt the standard as early as annual periods beginning after December 15, 2016, and interim periods therein. The standard permits the use of either the retrospective or cumulative effect transition method. We are evaluating the effect this amendment will have on our consolidated financial statements and related disclosures and believe the financial impact is not material. We have not yet selected a transition method.

In June 2014, the FASB issued ASU 2014-12, “Compensation – Stock Compensation (Topic 718).” ASU 2014-12 addresses accounting for share-based payments when the terms of an award provide that a performance target could be achieved after the requisite service period. ASU 2014-12 indicates that, in such situations, the performance target should be treated as a performance condition and, accordingly, the performance target should not be reflected in estimating the grant-date fair value of the award. Instead, compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved. ASU 2014-12 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. We do not expect the adoption of ASU 2014-12 to have a material effect on our financial position, results of operations or cash flows.

In February 2015, the FASB issued ASU 2015-02, “Consolidation (Topic 810).” ASU 2015-02 amends guidance regarding the consolidation of certain legal entities. ASU 2015-02 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015, with early adoption permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. We do not expect the adoption of ASU 2015-02 to have any effect on our financial position, results of operations or cash flows.

In April 2015, the FASB issued ASU 2015-03, “Interest – Imputation of Interest (Subtopic 835-30).” ASU 2015-03 amends guidance in order to simplify the presentation of debt issuance costs. ASU 2015-03 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015, with early adoption permitted for financial statements that have not been previously issued. We do not expect the adoption of ASU 2015-03 to have any effect on our financial position, results of operations or cash flows.

In July 2015, the FASB issued ASU 2015-11, “Simplifying the Measurement of Inventory (Topic 330).” ASU 2015-11 simplifies the accounting for the valuation of all inventory not accounted for using the last-in, first-out method by prescribing inventory be valued at the lower of cost and net realizable value. ASU 2015-11 is effective for public companies' annual periods, including interim periods within those fiscal years, beginning after December 15, 2016 on a prospective basis. Early adoption is permitted. We do not expect the adoption of ASU 2015-11 to have a material effect on our financial position, results of operations or cash flows.

In September 2015, the FASB issued ASU 2015-16, “Simplifying the Accounting for Measurement-Period Adjustments.” This guidance eliminated the requirement for retrospective adjustments to financial statements for measurement-period adjustments that occur after a business combination is consummated. ASU 2015-16 is effective for public companies' annual periods, including interim periods within those fiscal years, beginning after December 15, 2015 on a prospective basis. Early adoption is permitted. We do not expect the adoption of ASU 2015-16 to have any effect on our financial position, results of operations or cash flows.

Note 16. Subsequent Events

Acquisition

On October 13, 2015, we acquired the inventory, equipment and intangible assets of Concord Chrysler Jeep Dodge Fiat in Concord, California. We paid \$12.4 million in cash for this acquisition.

Common Stock Dividend

On October 19, 2015, our Board of Directors approved a dividend of \$0.20 per share on our Class A and Class B common stock related to our third quarter 2015 financial results. The dividend will total approximately \$4.7 million and will be paid on November 20, 2015 to shareholders of record on November 6, 2015.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements and Risk Factors

Certain statements under the sections entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Risk Factors" and elsewhere in this Form 10-Q constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Generally, you can identify forward-looking statements by terms such as "project", "outlook," "target", "may," "will," "would," "should," "seek," "expect," "plan," "intend," "anticipate," "believe," "estimate," "predict," "potential," "likely," "goal," "strategy," "future," "maintain," and "continue" or other comparable terms. Examples of forward-looking statements in this Form 10-Q include, among others, statements we make regarding:

Future market conditions;

Expected operating results, such as improved store performance; maintaining incremental throughput between 45% and 50%; continued improvement of SG&A as a percentage of gross profit and all projections;

Anticipated continued success and growth of DCH Auto Group;

Anticipated ability to capture additional market share;

Anticipated ability to find accretive acquisitions;

Anticipated additions of dealership locations to our portfolio in the future;

Anticipated availability of liquidity from our unfinanced operating real estate; and

Anticipated levels of capital expenditures in the future.

The forward-looking statements contained in this Form 10-Q involve known and unknown risks, uncertainties and situations that may cause our actual results to materially differ from the results expressed or implied by these statements. Certain important factors that could cause actual results to differ from our expectations are discussed in Part II - Other Information, Item 1A in this Form 10-Q and in the Risk Factors section of our 2014 Annual Report on Form 10-K, as supplemented and amended from time to time in Quarterly Reports on Form 10-Q and our other filings with the Securities and Exchange Commission.

By their nature, forward-looking statements involve risks and uncertainties because they relate to events that depend on circumstances that may or may not occur in the future. You should not place undue reliance on these forward-looking statements. Any forward-looking statement speaks only as of the date on which it is made. We assume no obligation to update or revise any forward-looking statement.

Overview

We are a leading operator of automotive franchises and a retailer of new and used vehicles and related services. As of October 30, 2015, we offered 31 brands of new vehicles and all brands of used vehicles in 135 stores in the United States and online at Lithia.com and DCHauto.com. We sell new and used cars and replacement parts; provide vehicle maintenance, warranty, paint and repair services; arrange related financing; and sell service contracts, vehicle

protection products and credit insurance.

Our dealerships are located across the United States. We seek domestic, import and luxury franchises in cities ranging from mid-sized regional markets to metropolitan markets. We evaluate all brands for expansion opportunities provided the market is large enough to support adequate new vehicle sales to justify the required capital investment.

Our mission statement is: “Driven by our employees and preferred by our customers, Lithia is the leading automotive retailer in each of our markets.” We offer customers convenient, flexible personalized service combined with the large company advantages of selection, competitive pricing, broad access to financing, and warranties. We strive for diversification in our products, services, brands and geographic locations to manage market risk and to maintain profitability. We have developed a centralized support structure to reduce store level administrative functions. This allows store personnel to focus on providing a positive customer experience. With our management information systems and centrally-performed administrative functions in Medford, Oregon, and regional accounting processing centers, we seek to gain economies of scale from our dealership network.

Results of Continuing Operations

For the three months ended September 30, 2015 and 2014, we reported income from continuing operations, net of tax, of \$43.4 million, or \$1.64 per diluted share, and \$34.5 million, or \$1.31 per diluted share, respectively.

For the nine months ended September 30, 2015 and 2014, we reported income from continuing operations, net of tax, of \$135.3 million, or \$5.10 per diluted share, and \$94.4 million, or \$3.58 per diluted share, respectively.

Discontinued Operations

In the third quarter of 2014, we early-adopted guidance that redefined discontinued operations. As a result, we determined that individual stores that met the criteria for held for sale after our adoption date would no longer qualify for classification as discontinued operations. We had previously reclassified a store’s operations to discontinued operations in our Consolidated Statements of Operations, on a comparable basis for all periods presented, provided we did not expect to have any significant continuing involvement in the store’s operations after its disposal.

We realized income from discontinued operations, net of tax, of \$3.2 million, or \$0.13 per diluted share for the nine months ended September 30, 2014. See Note 10 of the Condensed Notes to Consolidated Financial Statements for additional information.

Key Revenue and Gross Profit Metrics

Key performance metrics for revenue and gross profit were as follows (dollars in thousands):

| Three months ended September 30, 2015 | Revenues | Gross Profit | Gross Profit | Percent of |
|---------------------------------------|------------|--------------|--------------|------------|
| | Percent of | Profit | Profit | of |

Edgar Filing: LITHIA MOTORS INC - Form 10-Q

| | | Total | | | Margin | Total | |
|--------------------------------------|-------------|-----------------|---|-----------|---------------|---------------|---------|
| | | Revenues | | | | Gross | |
| | | | | | | Profit | |
| New vehicle | \$1,227,080 | 58.8 | % | \$77,157 | 6.3 | % | 24.8 % |
| Used vehicle retail | 505,885 | 24.3 | | 62,287 | 12.3 | | 20.0 |
| Used vehicle wholesale | 69,472 | 3.3 | | 580 | 0.8 | | 0.2 |
| Finance and insurance ⁽¹⁾ | 76,633 | 3.7 | | 76,633 | 100.0 | | 24.6 |
| Service, body and parts | 189,796 | 9.1 | | 93,950 | 49.5 | | 30.2 |
| Fleet and other | 15,979 | 0.8 | | 580 | 3.6 | | 0.2 |
| | \$2,084,845 | 100.0 | % | \$311,187 | 14.9 | % | 100.0 % |

| Three months ended September 30, 2014 | Revenues | Percent of | | Gross | Gross | Percent | | | | |
|--|-----------------|-------------------|---|--------------|--------------|----------------|---------|---------------|---------------|-----------|
| | | Total | | | | | | Profit | Margin | of |
| | | Revenues | | | | | | | | |
| | | | | | | | | | | |
| New vehicle | \$732,121 | 56.4 | % | \$47,648 | 6.5 | % | 24.1 % | | | |
| Used vehicle retail | 340,522 | 26.3 | | 43,898 | 12.9 | | 22.2 | | | |
| Used vehicle wholesale | 48,853 | 3.8 | | 504 | 1.0 | | 0.3 | | | |
| Finance and insurance ⁽¹⁾ | 46,855 | 3.6 | | 46,855 | 100.0 | | 23.7 | | | |
| Service, body and parts | 120,772 | 9.3 | | 58,421 | 48.4 | | 29.5 | | | |
| Fleet and other | 7,988 | 0.6 | | 514 | 6.4 | | 0.2 | | | |
| | \$1,297,111 | 100.0 | % | \$197,840 | 15.3 | % | 100.0 % | | | |

| Nine months ended September 30, 2015 | Revenues | Percent of | | Gross Profit | Gross Profit Margin | Percent of Total | |
|--------------------------------------|-------------|----------------|--------------|--------------|---------------------|------------------|---------|
| | | Total Revenues | Gross Profit | | | Gross Profit | Total |
| New vehicle | \$3,384,408 | 57.6 | % | \$208,273 | 6.2 | % | 23.6 % |
| Used vehicle retail | 1,457,617 | 24.8 | | 184,422 | 12.7 | | 20.9 |
| Used vehicle wholesale | 198,476 | 3.4 | | 4,147 | 2.1 | | 0.5 |
| Finance and insurance ⁽¹⁾ | 213,700 | 3.6 | | 213,700 | 100.0 | | 24.2 |
| Service, body and parts | 545,966 | 9.3 | | 269,138 | 49.3 | | 30.5 |
| Fleet and other | 70,803 | 1.3 | | 2,531 | 3.6 | | 0.3 |
| | \$5,870,970 | 100.0 | % | \$882,211 | 15.0 | % | 100.0 % |

| Nine months ended September 30, 2014 | Revenues | Percent of | | Gross Profit | Gross Profit Margin | Percent of Total | |
|--------------------------------------|-------------|----------------|--------------|--------------|---------------------|------------------|---------|
| | | Total Revenues | Gross Profit | | | Gross Profit | Total |
| New vehicle | \$2,006,127 | 55.8 | % | \$132,666 | 6.6 | % | 23.6 % |
| Used vehicle retail | 952,890 | 26.5 | | 128,761 | 13.5 | | 22.9 |
| Used vehicle wholesale | 135,832 | 3.8 | | 3,339 | 2.5 | | 0.6 |
| Finance and insurance ⁽¹⁾ | 130,324 | 3.6 | | 130,324 | 100.0 | | 23.2 |
| Service, body and parts | 339,726 | 9.4 | | 165,435 | 48.7 | | 29.4 |
| Fleet and other | 32,120 | 0.9 | | 1,676 | 5.2 | | 0.3 |
| | 3,597,019 | 100.0 | % | \$562,201 | 15.6 | % | 100.0 % |

(1)Commissions reported net of anticipated cancellations.

Same Store Operating Data

In 2014, we acquired 36 stores. As a result, we experienced significant growth in the first nine months of 2015 compared to the same period in 2014. We believe that same store comparisons are an important indicator of our financial performance. Same store measures demonstrate our ability to grow revenues in our existing locations. As a result, same store measures have been integrated into the discussion below.

Same store measures reflect results for stores that were operating in each comparison period and only include the months when operations occurred in both periods. For example, a store acquired in August 2014 would be included in same store operating data beginning in September 2015, after its first full complete comparable month of operation. The third quarter operating results for the same store comparisons would include results for that store in only the period of September for both comparable periods.

New Vehicle Revenue and Gross Profit

| (Dollars in thousands, except per unit amounts) Reported | Three Months Ended | | Increase (Decrease) | % Increase (Decrease) | |
|---|-----------------------|-----------|------------------------|-----------------------------|---|
| | September 30, 2015 | 2014 | | | |
| Revenue | \$1,227,080 | \$732,121 | \$494,959 | 67.6 | % |
| Gross profit | \$77,157 | \$47,648 | \$29,509 | 61.9 | |
| Gross margin | 6.3 | % 6.5 | % (20)bp | | |
| Retail units sold | 37,401 | 21,320 | 16,081 | 75.4 | |
| Average selling price per retail unit | \$32,809 | \$34,340 | \$(1,531) | (4.5) |) |
| Average gross profit per retail unit | \$2,063 | \$2,235 | \$(172) | (7.7) |) |
| Same store | | | | | |
| Revenue | \$810,720 | \$727,924 | \$82,796 | 11.4 | % |
| Gross profit | \$50,730 | \$47,211 | \$3,519 | 7.5 | |
| Gross margin | 6.3 | % 6.5 | % (20)bp | | |
| Retail units sold | 23,219 | 21,163 | 2,056 | 9.7 | |
| Average selling price per retail unit | \$34,916 | \$34,396 | \$520 | 1.5 | |
| Average gross profit per retail unit | \$2,185 | \$2,231 | \$(46) | (2.1) |) |

(1) A basis point is equal to 1/100th of one percent.

| (Dollars in thousands, except per unit amounts) Reported | Nine Months Ended | | Increase (Decrease) | % Increase (Decrease) | |
|---|-----------------------|-------------|------------------------|-----------------------------|---|
| | September 30, 2015 | 2014 | | | |
| Revenue | \$3,384,408 | \$2,006,127 | \$1,378,281 | 68.7 | % |
| Gross profit | \$208,273 | \$132,666 | \$75,607 | 57.0 | |
| Gross margin | 6.2 | % 6.6 | % (40)bp | | |
| Retail units sold | 103,136 | 59,040 | 44,096 | 74.7 | |
| Average selling price per retail unit | \$32,815 | \$33,979 | \$(1,164) | (3.4) |) |
| Average gross profit per retail unit | \$2,019 | \$2,247 | \$(228) | (10.1) |) |
| Same store | | | | | |
| Revenue | \$2,190,337 | \$1,988,665 | \$201,672 | 10.1 | % |
| Gross profit | \$136,224 | \$131,168 | \$5,056 | 3.9 | |
| Gross margin | 6.2 | % 6.6 | % (40)bp | | |
| Retail units sold | 63,113 | 58,431 | 4,682 | 8.0 | |
| Average selling price per retail unit | \$34,705 | \$34,034 | \$671 | 2.0 | |
| Average gross profit per retail unit | \$2,158 | \$2,245 | \$(87) | (3.9) |) |

(1) A basis point is equal to 1/100th of one percent.

New vehicle sales increased 67.6% and 68.7%, respectively, in the three- and nine-month periods ended September 30, 2015 compared to the same periods of 2014 primarily driven by the acquisition of 27 stores from the DCH Auto Group in the fourth quarter of 2014. On a same store basis, new vehicle sales increased 11.4% and 10.1%, respectively, primarily due to unit volume growth of 9.7% and 8.0%, respectively, in the three- and nine-month periods ended September 30, 2015 compared to the same periods in 2014.

Same store unit sales increased in all reportable segments in the 2015 periods compared to the comparable 2014 periods as follows:

| Three months ended | National growth in the three months ended | Nine months ended | National growth in the nine months ended |
|------------------------------------|---|------------------------------------|--|
| September 30, 2015 compared to the | September 30, 2015 compared | September 30, 2015 compared to the | September 30, 2015 compared |

| | same period of 2014 | | to the same period of 2014 | | same period of 2014 | | to the same period of 2014 | |
|----------|------------------------------------|---|---|---|------------------------------------|---|---|---|
| Domestic | 14.6 | % | 7.6 | % | 10.3 | % | 5.0 | % |
| Import | 4.7 | | 4.8 | | 5.7 | | 4.8 | |
| Luxury | 6.1 | | 7.3 | | 5.9 | | 7.3 | |
| Overall | 9.7 | % | 6.2 | % | 8.0 | % | 5.1 | % |

Our unit volume growth rate for the 2015 periods was higher than the national average for our domestic stores as we continued to gain market share within our markets. Unit volume growth for our import stores was nearly flat with the national average in the three months ended September 30, 2015 and had outperformed the national average in the nine-month period ended September 30, 2015. Our luxury stores lagged behind the national average for the three and nine months ended September 30, 2015, mainly associated with our BMW and Mercedes stores which experienced significant growth rates in 2014 that were not repeated in 2015. We continue to focus on increasing our share of overall new vehicle sales within our markets.

New vehicle gross profit increased 61.9% and 57.0%, respectively, for the three- and nine-month periods ended September 30, 2015 compared to the same periods of 2014, primarily driven by the acquisition of the DCH Auto Group in the fourth quarter of 2014. On a same store basis, new vehicle gross profit increased 7.5% and 3.9%, respectively, for the three- and nine-month periods ended September 30, 2015 compared to the same periods of 2014, primarily due to increased volume, partially offset by decreased gross profit per unit and lower gross margins.

With our volume-based strategy, on a same store basis, the average gross profit per new retail unit decreased \$46, or 2.1%, and \$87, or 3.9%, respectively, in the three- and nine-month periods ended September 30, 2015 compared to the same periods of 2014. We believe our volume-based strategy creates additional used vehicle trade-in opportunities, finance and insurance sales and future service work, which will generate incremental business in future periods that will more than offset the lower new vehicle gross profit per unit that has occurred as a result of this strategy.

Used Vehicle Retail Revenue and Gross Profit

| (Dollars in thousands, except per unit amounts) | Three Months Ended | | | | Increase (Decrease) | % Increase (Decrease) |
|---|--------------------|-----------|-----------|---|------------------------|-----------------------------|
| | September 30, | | | | | |
| Reported | 2015 | 2014 | | | | |
| Retail revenue | \$505,885 | \$340,522 | \$165,363 | | 48.6 | % |
| Retail gross profit | \$62,287 | \$43,898 | \$18,389 | | 41.9 | |
| Retail gross margin | 12.3 | % 12.9 | % (60)bp | | | |
| Retail units sold | 26,206 | 17,710 | 8,496 | | 48.0 | |
| Average selling price per retail unit | \$19,304 | \$19,228 | \$76 | | 0.4 | |
| Average gross profit per retail unit | \$2,377 | \$2,479 | \$(102) |) | (4.1) |) |
| Same store | | | | | | |
| Retail revenue | \$381,773 | \$338,400 | \$43,373 | | 12.8 | % |
| Retail gross profit | \$49,016 | \$43,716 | \$5,300 | | 12.1 | |
| Retail gross margin | 12.8 | % 12.9 | % (10)bp | | | |
| Retail units sold | 19,255 | 17,566 | 1,689 | | 9.6 | |
| Average selling price per retail unit | \$19,827 | \$19,264 | \$563 | | 2.9 | |
| Average gross profit per retail unit | \$2,546 | \$2,489 | \$57 | | 2.3 | |
| (Dollars in thousands, except per unit amounts) | Nine Months Ended | | | | Increase (Decrease) | % Increase (Decrease) |
| | September 30, | | | | | |
| Reported | 2015 | 2014 | | | | |
| Retail revenue | \$1,457,617 | \$952,890 | \$504,727 | | 53.0 | % |
| Retail gross profit | \$184,422 | \$128,761 | \$55,661 | | 43.2 | |
| Retail gross margin | 12.7 | % 13.5 | % (80)bp | | | |
| Retail units sold | 75,099 | 50,112 | 24,987 | | 49.9 | |
| Average selling price per retail unit | \$19,409 | \$19,015 | \$394 | | 2.1 | |
| Average gross profit per retail unit | \$2,456 | \$2,569 | \$(113) |) | (4.4) |) |

Same store

| | | | | | |
|---------------------------------------|-------------|-----------|------------|------|--------|
| Retail revenue | \$1,071,691 | \$943,360 | \$ 128,331 | 13.6 | % |
| Retail gross profit | \$141,666 | \$127,768 | \$ 13,898 | 10.9 | |
| Retail gross margin | 13.2 | % | 13.5 | % | (30)bp |
| Retail units sold | 54,197 | 49,537 | 4,660 | 9.4 | |
| Average selling price per retail unit | \$19,774 | \$19,044 | \$ 730 | 3.8 | |
| Average gross profit per retail unit | \$2,614 | \$2,579 | \$ 35 | 1.4 | |

Used vehicle retail sales are a strategic focus for organic growth. We offer three categories of used vehicles: manufacturer certified pre-owned vehicles; core vehicles, or late-model vehicles with lower mileage; and value autos, or vehicles with over 80,000 miles. Additionally, our volume-based strategy for new vehicle sales increases the organic opportunity to convert vehicles acquired via trade to retail used vehicle sales.

Same store sales increased in all three categories of used vehicles as follows:

| | Three months ended | | Nine months ended | |
|------------------------------|---|---|---|---|
| | September 30, 2015 compared to the same period of 2014 | | September 30, 2015 compared to the same period of 2014 | |
| Certified pre-owned vehicles | 20.5 | % | 19.6 | % |
| Core vehicles | 9.8 | | 12.3 | |
| Value autos | 10.7 | | 8.1 | |
| Overall | 12.8 | | 13.6 | |

The same store sales increases were a result of increased unit sales and increased average selling prices per unit as our mix shifted toward higher-priced certified pre-owned and core vehicles from value autos. This mix shift was primarily due to the increasing number of off-lease vehicles as a result of new vehicle sales volume increasing since 2010. The average new vehicle lease is approximately 30 months and, as a result of these lease terms ending and the vehicles returning, supply of late model used vehicles is up.

On an annualized average as of September 30, 2015 and 2014, each of our stores sold 61 and 55 retail used vehicle units, respectively, per month. We continue to target increasing sales to 75 units per store per month.

Used retail vehicle gross profit increased 41.9% and 43.2%, respectively, for the three- and nine-month periods ended September 30, 2015 compared to the same periods of 2014, primarily driven by the acquisition of the DCH Auto Group in the fourth quarter of 2014. On a same store basis, gross profit increased 12.1% and 10.9%, respectively, for the three- and nine-month periods ended September 30, 2015 compared to the same periods of 2014. These increases were mainly related to increased unit volume and increased gross profit per unit, partially offset by slight margin declines. The unit volume growth was driven by a mix shift toward certified pre-owned and core vehicles, which have higher average selling prices and higher gross profit per unit, but lower gross margins than value autos.

Used Vehicle Wholesale Revenue and Gross Profit

| | Three Months Ended | | Increase (Decrease) | % Increase (Decrease) | |
|--|-----------------------|----------|------------------------|--------------------------|---|
| | September 30, 2015 | 2014 | | | |
| (Dollars in thousands, except per unit amounts) | | | | | |
| Reported | | | | | |
| Wholesale revenue | \$69,472 | \$48,853 | \$ 20,619 | 42.2 | % |
| Wholesale gross profit | \$580 | \$504 | \$ 76 | 15.1 | |
| Wholesale gross margin | 0.8 % | 1.0 % | (20)bp | | |
| Wholesale units sold | 10,239 | 6,989 | 3,250 | 46.5 | |
| Average selling price per wholesale unit | \$6,785 | \$6,990 | \$ (205) | (2.9) | |
| Average gross profit per retail unit | \$57 | \$72 | \$ (15) | (20.8) | |
| Same store | | | | | |
| Wholesale revenue | \$54,088 | \$48,600 | \$ 5,488 | 11.3 | % |
| Wholesale gross profit | \$690 | \$544 | \$ 146 | 26.8 | |
| Wholesale gross margin | 1.3 % | 1.1 % | 20bp | | |
| Wholesale units sold | 7,226 | 6,916 | 310 | 4.5 | |
| Average selling price per wholesale unit | \$7,485 | \$7,027 | \$ 458 | 6.5 | |
| Average gross profit per retail unit | \$96 | \$79 | \$ 17 | 21.5 | |

| (Dollars in thousands, except per unit amounts) Reported | Nine Months Ended | | | | % Increase (Decrease) |
|---|-------------------|-----------|------------|--------|--------------------------|
| | September 30, | | Increase | | |
| | 2015 | 2014 | (Decrease) | | |
| Wholesale revenue | \$198,476 | \$135,832 | \$ 62,644 | 46.1 | % |
| Wholesale gross profit | \$4,147 | \$3,339 | \$ 808 | 24.2 | |
| Wholesale gross margin | 2.1 | % 2.5 | % (40)bp | | |
| Wholesale units sold | 28,822 | 18,889 | 9,933 | 52.6 | |
| Average selling price per wholesale unit | \$6,886 | \$7,191 | \$ (305) | (4.2) |) |
| Average gross profit per retail unit | \$144 | \$177 | \$ (33) | (18.6) |) |
| Same store | | | | | |
| Wholesale revenue | \$148,249 | \$135,173 | \$ 13,076 | 9.7 | % |
| Wholesale gross profit | \$3,741 | \$3,446 | \$ 295 | 8.6 | |
| Wholesale gross margin | 2.5 | % 2.5 | % 0bp | | |
| Wholesale units sold | 19,437 | 18,701 | 736 | 3.9 | |
| Average selling price per wholesale unit | \$7,627 | \$7,228 | \$ 399 | 5.5 | |
| Average gross profit per retail unit | \$192 | \$184 | \$ 8 | 4.3 | |

Wholesale transactions are vehicles we have purchased from customers or vehicles we have attempted to sell via retail that we elect to dispose of due to inventory age or other factors. Wholesale vehicles are typically sold at or near inventory cost and do not comprise a meaningful component of our gross profit.

Finance and Insurance

| (Dollars in thousands, except per unit amounts) Reported | Three Months Ended | | | | % Increase |
|---|--------------------|----------|----------|------|------------|
| | September 30, | | Increase | | |
| | 2015 | 2014 | | | |
| Revenue | \$76,633 | \$46,855 | \$29,778 | 63.6 | % |
| Average finance and insurance per retail unit | \$1,205 | \$1,200 | \$5 | 0.4 | |
| Same store | | | | | |
| Revenue | \$54,099 | \$46,607 | \$7,492 | 16.1 | % |
| Average finance and insurance per retail unit | \$1,274 | \$1,203 | \$71 | 5.9 | |

| | Nine Months Ended | | % | | |
|--|------------------------------|-------------|-----------------|-----------------|---|
| | September 30, | | | | |
| (Dollars in thousands, except per unit amounts) | 2015 | 2014 | Increase | Increase | |
| Reported | | | | | |
| Revenue | \$213,700 | \$130,324 | \$83,376 | 64.0 | % |
| Average finance and insurance per retail unit | \$1,199 | \$1,194 | \$5 | 0.4 | |
| Same store | | | | | |
| Revenue | \$148,232 | \$129,155 | \$19,077 | 14.8 | % |
| Average finance and insurance per retail unit | \$1,264 | \$1,196 | \$68 | 5.7 | |

The increases in total finance and insurance revenue were primarily due to higher unit volume, as a result of the acquisition of the DCH Auto Group in the fourth quarter of 2014. On a same store basis, the increases were due to higher unit volume sales and an increase in the average finance and insurance revenue earned per unit.

Trends in penetration rates for total new and used retail vehicles sold are detailed below:

| | Three Months Ended | | Nine Months Ended | |
|---|-----------------------------------|-------------|----------------------------------|-------------|
| | September 30, | | September 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| Finance and insurance | 77 % | 78 % | 77 % | 79 % |
| Service contracts | 42 | 43 | 42 | 43 |
| Lifetime lube, oil and filter contracts | 25 | 35 | 25 | 36 |

We believe the availability of credit is one of the key indicators of our ability to retail automobiles, as we arrange financing on almost 80% of the vehicles we sell and believe a significant amount of the vehicles we do not arrange financing for are financed elsewhere. To evaluate the availability of credit, we categorize our customers based on their Fair, Isaac and Company (FICO) credit score.

The distribution by credit score for the customers we arranged financing for was as follows:

| | | Three Months Ended | | Nine Months Ended | |
|-----------|-----------------------------|-----------------------------------|-------------|----------------------------------|-------------|
| | | September 30, | | September 30, | |
| | FICO Score Range | 2015 | 2014 | 2015 | 2014 |
| Prime | 680andabove | 71 % | 71 % | 70 % | 70 % |
| Non-prime | 620to 679 | 18 | 18 | 19 | 18 |
| Sub-prime | 619or less | 11 | 11 | 11 | 12 |

We continued to see the availability of consumer credit expand in the first nine months of 2015 compared to the same period of 2014.

Service, Body and Parts Revenue and Gross Profit

Three Months Ended**September 30,**

| (Dollars in thousands) | 2015 | 2014 | Increase | % Increase | |
|--------------------------------------|-------------|-------------|-----------------|-----------------------|---|
| Reported | | | | | |
| Customer pay | \$106,170 | \$66,348 | \$39,822 | 60.0 | % |
| Warranty | 43,449 | 21,869 | 21,580 | 98.7 | |
| Wholesale parts | 28,490 | 21,264 | 7,226 | 34.0 | |
| Body shop | 11,687 | 11,291 | 396 | 3.5 | |
| Total service, body and parts | \$189,796 | \$120,772 | \$69,024 | 57.2 | % |
| Service, body and parts gross profit | \$93,950 | \$58,421 | \$35,529 | 60.8 | % |
| Service, body and parts gross margin | 49.5 | % 48.4 | % 110bp | | |
| Same store | | | | | |
| Customer pay | \$71,304 | \$65,907 | \$5,397 | 8.2 | % |
| Warranty | 27,313 | 21,797 | 5,516 | 25.3 | |
| Wholesale parts | 22,028 | 21,104 | 924 | 4.4 | |
| Body shop | 11,687 | 11,291 | 396 | 3.5 | |
| Total service, body and parts | \$132,332 | \$120,099 | \$12,233 | 10.2 | % |
| Service, body and parts gross profit | \$64,822 | \$58,100 | \$6,722 | 11.6 | % |
| Service, body and parts gross margin | 49.0 | % 48.4 | % 60bp | | |

| Nine Months Ended | | | | | |
|--------------------------------------|-------------|-------------|-----------------|-----------------|------|
| September 30, | | | | | |
| (Dollars in thousands) | 2015 | 2014 | Increase | % | |
| | | | | Increase | |
| Reported | | | | | |
| Customer pay | \$ 307,491 | \$ 187,509 | \$ 119,982 | 64.0 | % |
| Warranty | 120,817 | 59,695 | 61,122 | 102.4 | |
| Wholesale parts | 83,093 | 61,007 | 22,086 | 36.2 | |
| Body shop | 34,565 | 31,515 | 3,050 | 9.7 | |
| Total service, body and parts | \$ 545,966 | \$ 339,726 | \$ 206,240 | 60.7 | % |
| Service, body and parts gross profit | \$ 269,138 | \$ 165,435 | \$ 103,703 | 62.7 | % |
| Service, body and parts gross margin | 49.3 | % | 48.7 | % | 60bp |
| Same store | | | | | |
| Customer pay | \$ 200,715 | \$ 185,616 | \$ 15,099 | 8.1 | % |
| Warranty | 75,660 | 59,297 | 16,363 | 27.6 | |
| Wholesale parts | 63,313 | 60,489 | 2,824 | 4.7 | |
| Body shop | 31,744 | 31,479 | 265 | 0.8 | |
| Total service, body and parts | \$ 371,432 | \$ 336,881 | \$ 34,551 | 10.3 | % |
| Service, body and parts gross profit | \$ 181,850 | \$ 163,944 | \$ 17,906 | 10.9 | % |
| Service, body and parts gross margin | 49.0 | % | 48.7 | % | 30bp |

Our service, body and parts sales grew in all areas in the three and nine-month periods ended September 30, 2015 compared to the same periods of 2014. There are more late-model vehicles in operation as new vehicle sales volumes have been increasing since 2010. We believe this increase in units in operation will benefit our service, body and parts sales in the coming years as more late-model vehicles age, necessitating repairs and maintenance.

We focus on retaining customers by offering competitively priced routine maintenance and through our marketing efforts. We increased our same store customer pay business 8.2% and 8.1%, respectively, in the three- and nine-month periods ended September 30, 2015 compared to the same periods in 2014.

Same store warranty sales increased 25.3% and 27.6%, respectively, in the three- and nine-month periods ended September 30, 2015 compared to the same periods of 2014, primarily due to significant numbers of vehicle recalls. Additionally, we continue to see increases due to the growing number of units in operation. Routine maintenance, such as oil changes, offered by certain brands, including BMW, Toyota and General Motors, for two to four years after a vehicle is sold, provides for future work as consumers return to the franchised dealer for this 'prepaid' maintenance item.

Increases in same-store warranty work by segment were as follows:

| | Three months ended | | Nine months ended | |
|----------|---|---|---|---|
| | September 30, 2015 compared to the same period of 2014 | | September 30, 2015 compared to the same period of 2014 | |
| Domestic | 18.5 | % | 29.5 | % |
| Import | 37.4 | % | 19.8 | % |
| Luxury | 27.2 | % | 32.4 | % |

Same store wholesale parts grew 4.4% and 4.7%, respectively, in the three- and nine-month periods ended September 30, 2015 compared to the same periods of 2014, primarily due to targeting fleet and mechanical wholesale accounts to expand our sales.

Same store body shop increased 3.5% and 0.8%, respectively, in the three- and nine-month periods ended September 30, 2015 compared to the same periods of 2014. These increases are a result of increased productivity and volume.

Same store service, body and parts gross profit increased 11.6% and 10.9%, respectively, in the three- and nine-month periods ended September 30, 2015 compared to the same periods of 2014. The growth in gross profit outpaced our revenue growth in both periods due to improvements in gross margin. Our gross margin improvements were driven by shifts in mix as the growth in warranty, which has a relatively higher gross margin, has outpaced customer pay, wholesale parts and body shop growth compared to the same periods in 2014.

Segments

Certain financial information by segment is as follows:

| (Dollars in thousands) | Three Months Ended | | Increase (Decrease) | % Increase (Decrease) | |
|------------------------|-----------------------|--------------|------------------------|--------------------------|---|
| | September 30, 2015 | 2014 | | | |
| Revenues: | | | | | |
| Domestic | \$814,155 | \$684,835 | \$ 129,320 | 18.9 | % |
| Import | 893,465 | 412,136 | 481,329 | 116.8 | |
| Luxury | 374,390 | 196,646 | 177,744 | 90.4 | |
| | 2,082,010 | 1,293,617 | 788,393 | 60.9 | |
| Corporate and other | 2,835 | 3,494 | (659) | (18.9) | |
| | \$2,084,845 | \$ 1,297,111 | \$ 787,734 | 60.7 | % |

| (Dollars in thousands) | Nine Months Ended | | Increase | % Increase | |
|------------------------|-----------------------|--------------|-------------|------------|---|
| | September 30, 2015 | 2014 | | | |
| Revenues: | | | | | |
| Domestic | \$2,272,914 | \$ 1,893,014 | \$379,900 | 20.1 | % |
| Import | 2,507,181 | 1,160,250 | 1,346,931 | 116.1 | |
| Luxury | 1,083,680 | 541,082 | 542,598 | 100.3 | |
| | 5,863,775 | 3,594,346 | 2,269,429 | 63.1 | |
| Corporate and other | 7,195 | 2,673 | 4,521 | 169.1 | |
| | \$5,870,970 | \$3,597,019 | \$2,273,950 | 63.2 | % |

| (Dollars in thousands) | Three Months Ended | | Increase (Decrease) | % Increase (Decrease) | | | |
|-------------------------|-----------------------|------|------------------------|--------------------------|----------|------|---|
| | September 30, 2015 | 2014 | | | | | |
| Segment income*: | | | | | | | |
| Domestic | | | \$33,176 | \$26,659 | \$ 6,517 | 24.4 | % |

Edgar Filing: LITHIA MOTORS INC - Form 10-Q

| | | | | |
|---|----------|----------|-----------|---------|
| Import | 30,506 | 13,407 | 17,099 | 127.5 |
| Luxury | 8,140 | 6,227 | 1,913 | 30.7 |
| | 71,822 | 46,293 | 25,529 | 55.1 |
| Corporate and other | 6,555 | 16,793 | (10,238) | (61.0) |
| Depreciation and amortization | (10,531) | (6,067) | 4,464 | 73.6 |
| Other interest expense | (4,900) | (2,051) | 2,849 | 138.9 |
| Other (expense) income, net | (307) | 1,027 | 1,334 | NM |
| Income from continuing operations before income taxes | \$62,639 | \$55,995 | \$ 6,644 | 11.9 % |

NM – not meaningful

| (Dollars in thousands) | Nine Months Ended | | | |
|---|-------------------|-----------|----------|------------|
| | September 30, | | Increase | % Increase |
| | 2015 | 2014 | | |
| Segment income*: | | | | |
| Domestic | \$91,691 | \$74,528 | \$17,163 | 23.0 % |
| Import | 73,963 | 37,351 | 36,612 | 98.0 |
| Luxury | 25,360 | 14,246 | 11,114 | 78.0 |
| | 191,014 | 126,125 | 64,889 | 51.4 |
| Corporate and other | 51,595 | 47,831 | 3,764 | 7.9 |
| Depreciation and amortization | (30,544) | (17,399) | 13,145 | 75.6 |
| Other interest expense | (14,700) | (5,894) | 8,806 | 149.4 |
| Other (expense) income, net | (1,031) | 3,110 | 4,140 | NM |
| Income from continuing operations before income taxes | \$196,334 | \$153,773 | \$42,561 | 27.7 % |

*Segment income for each reportable segment is defined as Income from continuing operations before income taxes, depreciation and amortization, other interest expense and other (expense) income, net.

| Retail new vehicle unit sales: | Three Months Ended | | | |
|--------------------------------|--------------------|--------|------------------------|--------------------------|
| | September 30, | | Increase (Decrease) | % Increase (Decrease) |
| | 2015 | 2014 | | |
| Domestic | 12,361 | 10,398 | 1,963 | 18.9 % |
| Import | 20,658 | 8,921 | 11,737 | 131.6 |
| Luxury | 4,455 | 2,006 | 2,449 | 122.1 |
| | 37,474 | 21,325 | 16,149 | 75.7 |
| Allocated to management | (73) | (5) | (68) | NM |
| | 37,401 | 21,320 | 16,081 | 75.4 % |

| Retail new vehicle unit sales: | Nine Months Ended | | | |
|--------------------------------|-------------------|--------|------------------------|--------------------------|
| | September 30, | | Increase (Decrease) | % Increase (Decrease) |
| | 2015 | 2014 | | |
| Domestic | 33,852 | 28,989 | 4,863 | 16.8 % |
| Import | 56,814 | 24,632 | 32,182 | 130.7 |
| Luxury | 12,650 | 5,583 | 7,067 | 126.6 |
| | 103,316 | 59,204 | 44,112 | 74.5 |
| Allocated to management | (180) | (164) | (16) | NM |
| | 103,136 | 59,040 | 44,096 | 74.7 % |

NM – Not meaningful.

Domestic

A summary of financial information for our Domestic segment follows:

| | Three Months Ended | | | | |
|-------------------------------|---------------------------|-------------|-----------------|-------------------|---|
| | September 30, | | | | |
| (Dollars in thousands) | 2015 | 2014 | Increase | % Increase | |
| Revenue | \$814,155 | \$684,835 | \$129,320 | 18.9 | % |
| Segment income | \$33,176 | \$26,659 | \$6,517 | 24.4 | |
| Retail new vehicle unit sales | 12,361 | 10,398 | 1,963 | 18.9 | |

| | Nine Months Ended | | | | |
|-------------------------------|--------------------------|-------------|-----------------|-------------------|---|
| | September 30, | | | | |
| (Dollars in thousands) | 2015 | 2014 | Increase | % Increase | |
| Revenue | \$2,272,914 | \$1,893,014 | \$379,900 | 20.1 | % |
| Segment income | \$91,691 | \$74,528 | \$17,163 | 23.0 | |
| Retail new vehicle unit sales | 33,852 | 28,989 | 4,863 | 16.8 | |

Improvement in our Domestic segment revenue in the three-month period ended September 30, 2015 compared to the same period of 2014 was primarily a result of increases in retail new and used unit sales, increases in new and used vehicle selling prices, an increase in finance and insurance as a function of greater retail vehicle unit volume and improved service body and parts sales. These increases were driven by an improving economic environment, new product introductions from our manufacturer partners, enhanced availability of late model used vehicles and better operational execution within our stores. Chrysler, which represented 53% of our domestic segment revenue in the three-month period ended September 30, 2015, increased its U.S. market share 10 bps to 6.8% in the three months ended September 30, 2015 compared to the same period in 2014. Segment retail new vehicle unit sales increased 18.9% in the three months ended September 30, 2015 compared to the same period in 2014, as same store new unit sales increased 14.6%, with the remaining increase primarily a function of two stores acquired in 2015.

Revenue for the Domestic segment increased in all lines of the business in the nine-month period ended September 30, 2015 compared to the same period of 2014. Chrysler, which represented 53% of our domestic segment revenue in the nine-month period ended September 30, 2015, increased its U.S. market share 10 bps to 6.3% in the nine months ended September 30, 2015 compared to the same period in 2014. Segment retail new vehicle unit sales increased 16.8% in the nine months ended September 30, 2015 compared to the same period in 2014, as same store new unit sales increased 10.3%, with the remaining increase primarily a function of two stores acquired in 2015.

Our Domestic segment income increased 24.4% and 23.0%, respectively, in the three- and nine-month periods ended September 30, 2015 compared to the same periods in 2014. The increases exceed both the increases in revenue and retail new vehicle unit sales primarily as a result of a volume-based retail vehicle strategy, while managing selling, general and administrative expenses.

Import

A summary of financial information for our Import segment follows:

| (Dollars in thousands) | Three Months Ended | | Increase | % Increase | |
|-------------------------------|---------------------------|-------------|-----------------|-------------------|---|
| | 2015 | 2014 | | | |
| | September 30, | | | | |
| Revenue | \$893,465 | \$412,136 | \$481,329 | 116.8 | % |
| Segment income | \$30,506 | \$13,407 | \$17,099 | 127.5 | |
| Retail new vehicle unit sales | 20,658 | 8,921 | 11,737 | 131.6 | |

Nine Months Ended

September 30,

| (Dollars in thousands) | 2015 | 2014 | Increase | % Increase | |
|-------------------------------|-------------|-------------|-----------------|-----------------------|---|
| Revenue | \$2,507,181 | \$1,160,250 | \$1,346,931 | 116.1 | % |
| Segment income | \$73,963 | \$37,351 | \$36,612 | 98.0 | |
| Retail new vehicle unit sales | 56,814 | 24,632 | 32,182 | 130.7 | |

Increases in our Import segment revenue in the three- and nine-month periods ended September 30, 2015 compared to the same periods of 2014 were primarily a result of the acquisition of the DCH Auto Group in October 2014. Of the 27 stores acquired in the DCH Auto Group, 17 of the locations were import branded and over 90% of their revenues were import segment based.

Our Import segment income increased 127.5% and 98.0%, respectively, in the three- and nine-month periods ended September 30, 2015 compared to the same periods in 2014 primarily as a result of the DCH Auto Group acquisition. The increase in segment income in the three-month period exceeded the increase in revenue as we focus on integrating the DCH Auto Group into our existing cost structure, which is more efficient than their historical structure. Import segment income, as a percentage of revenue, improved 20 basis points to 3.5% for the three-months ended September 30, 2015 compared to the same period of 2014.

The increase in segment income in the nine-month period was less than the increase in revenue in the nine-month period due to the integration of the DCH Auto Group as it historically had a higher cost structure than our existing stores and uses a high-volume, low-margin strategy. The DCH Auto Group stores face more competitive dynamics as the stores are in high-density metropolitan locations.

Luxury

A summary of financial information for our Luxury segment follows:

| | Three Months Ended | | | |
|-------------------------------|---------------------------|-------------|-----------------|-------------------|
| | September 30, | | | |
| (Dollars in thousands) | 2015 | 2014 | Increase | % Increase |
| Revenue | \$374,390 | \$196,646 | \$177,744 | 90.4 % |
| Segment income | \$8,140 | \$6,227 | \$1,913 | 30.7 |
| Retail new vehicle unit sales | 4,455 | 2,006 | 2,449 | 122.1 |

| | Nine Months Ended | | | |
|-------------------------------|--------------------------|-------------|-----------------|-------------------|
| | September 30, | | | |
| (Dollars in thousands) | 2015 | 2014 | Increase | % Increase |
| Revenue | \$1,083,680 | \$541,083 | \$542,597 | 100.3 % |
| Segment income | \$25,360 | \$14,246 | \$11,114 | 78.0 |
| Retail new vehicle unit sales | 12,650 | 5,583 | 7,067 | 126.6 |

Our luxury segment revenue increased 90.4% and 100.3%, respectively, in the three- and nine-month periods ended September 30, 2015 compared to the same periods in 2014 primarily as a result of the acquisition of the DCH Auto Group, which included nine luxury stores in metropolitan markets that are typically higher volume stores than our historical markets.

Our luxury segment income increased 30.7% and 78.0%, respectively, in the three- and nine-month periods ended September 30, 2015 compared to the same periods in 2014. These increases underperformed both the increases in revenue and retail new vehicle unit sales primarily as a result of lower gross margins. The DCH Auto Group stores use a high-volume, low-margin strategy and face more competitive dynamics as the stores are in high-density metropolitan locations. Additionally, the DCH Auto Group has less efficient selling, general and administrative expense control than we have historically had, which resulted in lower total Luxury segment income as a percentage of revenue due to the averaging of the cost structures.

Corporate and Other

Revenues attributable to Corporate and other include the results of operations of our stand-alone collision center offset by certain unallocated reserve and elimination adjustments related to vehicle sales.

The decrease in Corporate and other revenue in the three-month period ended September 30, 2015 compared to the same period of 2014 was primarily a result of an increase in unallocated eliminations related to new vehicle sales, offset by increased revenues for our stand-alone body shop.

The increase in Corporate and other revenues in the nine-month period ended September 30, 2015 compared to the same period of 2014 was primarily a result of increased revenues for our stand-alone body shop.

Segment income attributable to Corporate and other includes amounts associated with the operating income from our stand-alone body shop and certain internal corporate expense allocations that reduce reportable segment income but increase Corporate and other income. These internal corporate expense allocations are used to increase comparability of our dealerships and reflect the capital burden a stand-alone dealership would experience. Examples of these internal allocations include internal rent expense, internal floor plan financing charges, and internal fees charged to offset employees within our corporate headquarters who perform certain dealership functions.

The \$10.2 million decrease in Corporate and other segment income in the three-month period ended September 30, 2015 compared to the same period of 2014 was primarily a result of the recording of an \$18.3 million charge associated with a transition agreement for Mr. Sidney B. DeBoer, offset by reduced expense associated with certain insurance reserves adjustments. See Note 13 of Condensed Notes to Consolidated Financial Statements elsewhere in this Form 10-Q for additional information regarding the transition agreement.

The \$3.8 million increase in Corporate and other segment income in the nine-month period ended September 30, 2015 compared to the same period of 2014 was primarily related to increased internal corporate expense allocations for the capital burden of higher inventory levels, partially offset by the transition agreement charge discussed above.

Asset Impairments

Asset impairments recorded as a component of continuing operations consist of the following (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|-------------------|-----------------------------------|-------------|------------------------------|-------------|
| | September 30, | | September 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| Equity investment | \$4,131 | \$ - | \$12,391 | \$ - |
| Long-lived assets | - | - | 2,000 | - |

Asset impairments of our equity investment are associated with our investment in a limited liability company that participates in the New Markets Tax Credit Program (“NMTC Program”). The equity-method investment generates operating losses on a quarterly basis and, accordingly, we will be required to assess the investment for other than temporary impairment on a quarterly basis. The investment provides a return in the form of tax credits. We recorded a reduction to our income tax provision of \$7.4 million and \$22.3 million, respectively, related to tax credits under the NMTC Program in the three- and nine-month periods ended September 30, 2015. See Note 12 of Condensed Notes to Consolidated Financial Statements elsewhere in this Form 10-Q for additional information.

In the second quarter of 2015, we recorded \$2.0 million of impairment charges associated with certain properties. As the expected future use of these facilities changed, the long-lived assets were tested for recoverability and were determined to have a carrying value exceeding the fair value of these properties.

Selling, General and Administrative Expense (“SG&A”)

SG&A includes salaries and related personnel expenses, advertising (net of manufacturer cooperative advertising credits), rent, facility costs, and other general corporate expenses.

| | Three Months Ended | | | | |
|-------------------------------|---------------------------|-------------|-----------------|-------------------|---|
| | September 30, | | | | |
| (Dollars in thousands) | 2015 | 2014 | Increase | % Increase | |
| Personnel | \$ 157,365 | \$ 88,205 | \$ 69,160 | 78.4 | % |
| Advertising | 18,117 | 10,887 | 7,230 | 66.4 | |
| Rent | 5,689 | 3,874 | 1,815 | 46.9 | |
| Facility costs | 11,413 | 7,749 | 3,664 | 47.3 | |
| Other | 31,144 | 20,912 | 10,232 | 48.9 | |
| Total SG&A | \$ 223,728 | \$ 131,627 | \$ 92,101 | 70.0 | % |

| | Three Months Ended | | Increase | |
|-------------------------------|-----------------------------------|-------------|-------------------|----|
| | September 30, | | | |
| As a % of gross profit | 2015 | 2014 | (Decrease) | |
| Personnel | 50.6% | 44.6% | 600 | bp |
| Advertising | 5.8 | 5.5 | 30 | |
| Rent | 1.8 | 2.0 | (20 |) |
| Facility costs | 3.7 | 3.9 | (20 |) |
| Other | 10.0 | 10.5 | (50 |) |
| Total SG&A | 71.9% | 66.5% | 540 | bp |

| | Nine Months Ended | | Increase | | % Increase | |
|-------------------------------|------------------------------|-------------|-----------------|------|-----------------------|--|
| | September 30, | | | | | |
| (Dollars in thousands) | 2015 | 2014 | Increase | | | |
| Personnel | \$424,384 | \$254,213 | \$170,171 | 66.9 | % | |
| Advertising | 50,267 | 30,946 | 19,321 | 62.4 | | |
| Rent | 17,303 | 11,192 | 6,111 | 54.6 | | |
| Facility costs | 28,214 | 22,634 | 5,580 | 24.7 | | |
| Other | 90,788 | 59,934 | 30,854 | 51.5 | | |
| Total SG&A | \$610,956 | \$378,919 | \$232,037 | 61.2 | % | |

| | Nine Months Ended | | Increase | |
|-------------------------------|------------------------------|-------------|-------------------|----|
| | September 30, | | | |
| As a % of gross profit | 2015 | 2014 | (Decrease) | |
| Personnel | 48.1% | 45.2% | 290 | bp |
| Advertising | 5.7 | 5.5 | 20 | |
| Rent | 2.0 | 2.0 | - | |
| Facility costs | 3.2 | 4.0 | (80 |) |
| Other | 10.3 | 10.7 | (40 |) |
| Total SG&A | 69.3% | 67.4% | 190 | bp |

The 70.0% and 61.2% increases, respectively, in SG&A in the three- and nine-month periods ended September 30, 2015 compared to the same periods of 2014 were primarily driven by increased variable cost associated with increased sales volume and store count, as well as an \$18.3 million charge associated with a transition agreement. Offsetting these factors was a non-core charge of \$0.9 million and \$1.1 million, respectively, related to acquisition expenses for the acquisition of DCH Auto Group in the three- and nine-month periods of 2014.

SG&A expense in the nine-month period of 2015 is offset by a \$5.9 million gain associated with the sale of two stores. Additionally, the nine-months ended September 30, 2014 included non-core charges totaling \$3.9 million related to a reserve adjustments associated with a lawsuit filed in 2006 and settled in 2013, a loss reserve for a hailstorm in Texas and a reserve for a contract assumed in an acquisition.

SG&A expense adjusted for non-core charges was as follows (in thousands):

| | Three Months Ended | | | | |
|-------------------------------|---------------------------|-------------|-----------------|-------------------|---|
| | September 30, | | | | |
| (Dollars in thousands) | 2015 | 2014 | Increase | % Increase | |
| Personnel | \$ 139,069 | \$ 88,205 | \$ 50,864 | 57.7 | % |
| Advertising | 18,117 | 10,887 | 7,230 | 66.4 | |
| Rent | 5,689 | 3,874 | 1,815 | 46.9 | |
| Adjusted facility costs | 11,413 | 7,749 | 3,664 | 47.3 | |
| Adjusted other | 31,144 | 20,029 | 11,115 | 55.5 | |
| Adjusted total SG&A | \$ 205,432 | \$ 130,744 | \$ 74,688 | 57.1 | % |

| | Three Months Ended | | | Increase |
|-------------------------------|-----------------------------------|-------------|-------------------|-----------------|
| | September 30, | | | |
| As a % of gross profit | 2015 | 2014 | (Decrease) | |
| Personnel | 44.7% | 44.6% | 10 | bp |
| Advertising | 5.8 | 5.5 | 30 | |
| Rent | 1.8 | 2.0 | (20 |) |
| Adjusted facility costs | 3.7 | 3.9 | (20 |) |
| Adjusted other | 10.0 | 10.1 | (10 |) |
| Adjusted total SG&A | 66.0% | 66.1% | (10 |)bp |

| | Nine Months Ended | | | |
|-------------------------------|------------------------------|-------------|-----------------|-----------------------|
| | September 30, | | | |
| (Dollars in thousands) | 2015 | 2014 | Increase | % Increase |
| Personnel | \$406,087 | \$254,213 | \$151,874 | 59.7 % |
| Advertising | 50,267 | 30,946 | 19,321 | 62.4 |
| Rent | 17,303 | 11,192 | 6,111 | 54.6 |
| Adjusted facility costs | 34,133 | 22,634 | 11,499 | 50.8 |
| Adjusted other | 90,789 | 54,957 | 35,832 | 65.2 |
| Adjusted total SG&A | \$598,579 | \$373,942 | \$224,637 | 60.1 % |

| | Nine Months Ended | | | Increase |
|-------------------------------|------------------------------|-------------|-------------------|-----------------|
| | September 30, | | | |
| As a % of gross profit | 2015 | 2014 | (Decrease) | |
| Personnel | 46.0% | 45.2% | 80 | bp |
| Advertising | 5.7 | 5.5 | 20 | |
| Rent | 2.0 | 2.0 | - | |
| Adjusted facility costs | 3.9 | 4.0 | (10 |) |
| Adjusted other | 10.2 | 9.8 | 40 | |
| Adjusted total SG&A | 67.8% | 66.5% | 130 | bp |

See “Non-GAAP Reconciliations” for more details.

We also measure the leverage of our cost structure by evaluating throughput, which is the incremental percentage of gross profit retained after deducting SG&A expense.

| | Three Months Ended | | | % of Change in Gross Profit | |
|-------------------------|--------------------|-----------|-----------|---|---|
| | September 30, | | | | |
| (Dollars in thousands) | 2015 | 2014 | Change | | |
| Gross profit | \$311,187 | \$197,840 | \$113,347 | 100.0 | % |
| SG&A expense | (223,728) | (131,627) | (92,101) | (81.3) |) |
| Throughput contribution | | | \$21,246 | 18.7 | % |

| | Nine Months Ended | | | % of Change in Gross Profit | |
|-------------------------|-------------------|-----------|-----------|---|---|
| | September 30, | | | | |
| (Dollars in thousands) | 2015 | 2014 | Change | | |
| Gross profit | \$882,211 | \$562,201 | \$320,010 | 100.0 | % |
| SG&A expense | (610,956) | (378,919) | (232,037) | (72.5) |) |
| Throughput contribution | | | \$87,973 | 27.5 | % |

Throughput contributions for newly opened or acquired stores reduce overall throughput because, in the first year of operation, a store's throughput is equal to the inverse of its SG&A as a percentage of gross profit. For example, a store which achieves SG&A as a percentage of gross profit of 70% will have throughput of 30% in the first year of operation.

We opened one new store and acquired 31 stores since September 30, 2014. Adjusting for these locations and the non-core adjustments discussed above, our throughput contribution on a same store basis was 49.3% and 41.4%, respectively for the three- and nine-month periods ended September 30, 2015. We continue to target a same store throughput contribution in a range of 45% to 50%.

Depreciation and Amortization

Depreciation and amortization is comprised of depreciation expense related to buildings, significant remodels or improvements, furniture, tools, equipment and signage and amortization of certain intangible assets, including customer lists and non-compete agreements.

| | Three Months Ended | | | | |
|-------------------------------|---------------------------|-------------|-----------------|-----------------|----------|
| | | | | | <i>%</i> |
| (Dollars in thousands) | September 30, | | | | |
| | 2015 | 2014 | Increase | Increase | |
| Depreciation and amortization | \$10,531 | \$6,067 | \$4,464 | 73.6 | <i>%</i> |

| | Nine Months Ended | | | | |
|-------------------------------|--------------------------|-------------|-----------------|-----------------|----------|
| | | | | | <i>%</i> |
| (Dollars in thousands) | September 30, | | | | |
| | 2015 | 2014 | Increase | Increase | |
| Depreciation and amortization | \$30,544 | \$17,399 | \$13,145 | 75.6 | <i>%</i> |

The increases in depreciation and amortization in the three- and nine-month periods ended September 30, 2015 compared to the same periods of 2014 were primarily due to our acquisition activity since September 30, 2014. Additionally, we purchased previously leased facilities, built new facilities subsequent to the acquisition of stores and invested in improvements at our facilities and replacement of equipment. These investments increase the amount of depreciable assets and amortizable expenses. In the full year of 2014 and the first nine months of 2015, we had capital expenditures of \$86.0 million and \$62.2 million, respectively.

Operating Income

Operating income as a percentage of revenue, or operating margin, was as follows:

| | Three Months Ended | | Nine Months Ended | |
|---|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| Operating margin | 3.5% | 4.6% | 3.9% | 4.6% |
| Operating margin adjusted for non-core charges ⁽¹⁾ | 4.6% | 4.7% | 4.3% | 4.8% |

⁽¹⁾ See “Non-GAAP Reconciliations” for more details.

Due to the effects of the integration of the DCH Auto Group, which has a lower operating efficiency than our other stores, we expect our operating margin to be in the low 4% range throughout 2015. In the three- and nine-month periods ended September 30, 2015, our operating margin was impacted by a charge of \$18.3 million associated with a reserve for a transition agreement with Mr. Sidney B. DeBoer. Adjusting for this and other non-core charges, our operating margin was 4.6% and 4.3%, respectively, for the three- and nine-month periods ended September 30, 2015. We continue to focus on cost control, which allows us to leverage our cost structure in an environment of improving sales and aspire to increase our operating margin to our historical level.

Floor Plan Interest Expense and Floor Plan Assistance

Floor plan interest expense increased \$1.8 million and \$4.9 million, respectively, in the three- and nine-month periods ended September 30, 2015 compared to the same periods of 2014 primarily as a result of increases in the average outstanding balances on our floor plan facilities due to our increases in vehicle sales as discussed above.

Floor plan assistance is provided by manufacturers to support store financing of new vehicle inventory. Under accounting standards, floor plan assistance is recorded as a component of new vehicle gross profit when the specific vehicle is sold. However, because manufacturers provide this assistance to offset inventory carrying costs, we believe a comparison of floor plan interest expense to floor plan assistance is a useful measure of the efficiency of our new vehicle sales relative to stocking levels.

The following tables detail the carrying costs for new vehicles and include new vehicle floor plan interest net of floor plan assistance earned.

| (Dollars in thousands) | Three Months Ended | | | |
|--|---------------------------|-------------|---------------|---------------|
| | % | | | |
| | September 30, 2015 | 2014 | Change | Change |
| Floor plan interest expense (new vehicles) | \$4,951 | \$3,127 | \$ 1,824 | 58.3 % |
| Floor plan assistance (included as an offset to cost of sales) | (11,245) | (7,073) | 4,172 | 59.0 |
| Net new vehicle carrying costs | \$(6,294) | \$(3,946) | \$ 2,348 | (59.5) |

| (Dollars in thousands) | Nine Months Ended | | | |
|--|---------------------------|-------------|---------------|---------------|
| | % | | | |
| | September 30, 2015 | 2014 | Change | Change |
| Floor plan interest expense (new vehicles) | \$14,255 | \$9,326 | \$4,929 | 52.9 % |
| Floor plan assistance (included as an offset to cost of sales) | (30,919) | (19,497) | 11,422 | 58.6 |
| Net new vehicle carrying costs | \$(16,664) | \$(10,171) | \$6,493 | (63.8) |

Other Interest Expense

Other interest expense includes interest on debt incurred related to acquisitions, real estate mortgages, our used vehicle inventory financing facility and our revolving line of credit.

| (Dollars in thousands) | Three Months Ended | | | |
|-------------------------------|---------------------------|-------------|-------------------|-------------------|
| | Increase | | | |
| | September 30, 2015 | 2014 | (Decrease) | % Increase |
| Mortgage interest | \$3,430 | \$1,589 | \$ 1,841 | 115.9 % |
| Other interest | 1,584 | 546 | 1,038 | 190.1 |
| Capitalized interest | (114) | (84) | (30) | 35.7 |
| Total other interest expense | \$4,900 | \$2,051 | \$ 2,849 | 138.9 % |

| Nine Months Ended | | | |
|--------------------------|--|--|--|
| Increase | | | |
| September 30, | | | |

| (Dollars in thousands) | 2015 | 2014 | (Decrease) | % Increase | |
|-------------------------------|-------------|-------------|-------------------|-----------------------|---|
| Mortgage interest | \$9,786 | \$4,593 | \$ 5,193 | 113.1 | % |
| Other interest | 5,200 | 1,515 | 3,685 | 243.2 | |
| Capitalized interest | (286) | (214) | (72) | 33.6 | |
| Total other interest expense | \$14,700 | \$5,894 | \$ 8,806 | 149.4 | % |

The increases in other interest expense in the first three and nine months of 2015 compared to the same periods of 2014 were primarily due to higher volumes of borrowing on our credit facility and higher mortgage interest due to additional mortgage financings, partially offset by increased capitalized interest.

Other (Expense) Income, Net

Other (expense) income, net primarily includes interest income and the gains and losses related to an equity-method investments.

Three Months Ended

September 30,

| (Dollars in thousands) | 2015 | 2014 | Increase | % Increase | |
|-------------------------------|-------------|-------------|-----------------|-----------------------|---|
| Other (expense) income, net | \$(307) | \$1,027 | \$ 1,334 | 129.9 | % |

Nine Months Ended

September 30,

| (Dollars in thousands) | 2015 | 2014 | Increase | % Increase | |
|-------------------------------|-------------|-------------|-----------------|-----------------------|---|
| Other (expense) income, net | \$(1,031) | \$3,110 | \$ 4,141 | 133.2 | % |

Income Tax Expense

Our effective income tax rate was as follows:

| | Three Months Ended | | Nine Months Ended | |
|--|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| Effective income tax rate | 30.7% | 38.3% | 31.1% | 38.6% |
| Effective income tax rate excluding tax credits generated through our equity-method investment and other non-core items ⁽¹⁾ | 38.2% | 38.6% | 38.7% | 38.8% |

⁽¹⁾ See “Non-GAAP Reconciliations” for more details.

Our effective income tax rate was 30.7% and 31.1% for the three- and nine-month periods ended September 30, 2015 compared to 38.3% and 38.6%, respectively, in the comparable periods of 2014. For the full year of 2015, we forecast our income tax rate to be approximately 31.1%.

Our effective income tax rate in the first nine months of 2015 was positively affected by new markets tax credits that are generated through our equity-method investment with U.S. Bancorp Community Development Corporation. Excluding this investment and adjusting for other non-core items, we forecast our income tax rate to be 38.7% for the full year 2015.

Non-GAAP Reconciliations

We believe each of the non-GAAP financial measures below improves the transparency of our disclosures, provides a meaningful presentation of our results from the core business operations because they exclude adjustments for items not related to our ongoing core business operations and other non-cash adjustments, and improves the period-to-period comparability of our results from the core business operations. We use these measures in conjunction with GAAP financial measures to assess our business, including our compliance with covenants in our credit facility and in communications with our Board of Directors concerning financial performance. These measures should not be considered an alternative to GAAP measures.

Edgar Filing: LITHIA MOTORS INC - Form 10-Q

The following tables reconcile certain reported non-GAAP measures to the most comparable GAAP measure from our Consolidated Statements of Operations (dollars in thousands, except per share amounts):

Three Months Ended September 30, 2015

| | As reported | Equity-method investment | Transition Agreement | Adjusted |
|---|--------------------|---------------------------------|-----------------------------|-----------------|
| Asset impairment | \$4,131 | \$ (4,131 |) \$ - | \$- |
| Selling, general and administrative | 223,728 | - | (18,296) | 205,432 |
| Operating income | 72,797 | 4,131 | 18,296 | 95,224 |
| Other (expense) income | (307) | 1,731 | - | 1,424 |
| Income from continuing operations before income taxes | \$62,639 | \$ 5,862 | \$ 18,296 | \$86,797 |
| Income tax provision | (19,248) | (7,414 |) (6,507) | (33,169) |
| Income (loss) from continuing operations, net of income tax | \$43,391 | \$ (1,552 |) \$ 11,789 | \$53,628 |
| Diluted income (loss) per share from continuing operations | \$1.64 | \$ (0.05 |) \$ 0.44 | \$2.03 |
| Diluted share count | 26,480 | | | |

Three Months Ended September 30, 2014

| | As reported | Acquisition expenses | Tax attributes | Adjusted |
|---|--------------------|-----------------------------|-----------------------|-----------------|
| Selling, general and administrative | \$131,627 | \$ (883) | \$ - | \$130,744 |
| Income from operations | 60,146 | 883 | - | 61,029 |
| Income from continuing operations before income taxes | \$55,995 | \$ 883 | \$ - | \$56,878 |
| Income tax expense | (21,458) | (319) | (194) | (21,971) |
| Net income from continuing operations | \$34,537 | \$ 564 | \$ (194) | \$34,907 |
| Diluted earnings per share from continuing operations | \$1.31 | \$ 0.02 | \$ (0.01) | \$1.32 |
| Diluted share count | 26,359 | | | |

Nine Months Ended September 30, 2015

| | As reported | Disposal gain on sale of stores | Asset impairment | Equity-method investment | Transition Agreement | Adjusted |
|--|--------------------|--|-------------------------|---------------------------------|-----------------------------|-----------------|
| Asset impairment | \$14,391 | \$- | \$ (2,000) | \$ (12,391) | \$ - | \$- |
| Selling, general and administrative | 610,956 | 5,919 | - | - | (18,296) | 598,579 |
| Operating income (loss) | 226,320 | (5,919) | 2,000 | 12,391 | 18,296 | 253,088 |
| Other (expense) income | (1,031) | - | - | 5,196 | - | 4,165 |
| Income (loss) from continuing operations before income taxes | \$196,334 | \$(5,919) | \$ 2,000 | \$ 17,587 | \$ 18,296 | \$228,298 |
| Income tax (provision) benefit | (61,067) | 2,309 | (780) | (22,316) | (6,507) | (88,361) |
| Income (loss) from continuing operations, net of income tax | \$135,267 | \$(3,610) | \$ 1,220 | \$ (4,729) | \$ 11,789 | \$139,937 |
| Diluted income (loss) per share from continuing operations | \$5.10 | \$(0.14) | \$ 0.05 | \$ (0.18) | \$ 0.45 | \$5.28 |
| Diluted share count | 26,500 | | | | | |

Nine Months Ended September 30, 2014

| | As reported | Reserve adjustments | Acquisition expenses | Tax attribute | Adjusted |
|---|--------------------|----------------------------|-----------------------------|----------------------|-----------------|
| Selling, general and administrative | \$378,919 | \$ (3,931) | \$ (1,046) | \$ - | \$373,942 |
| Income from operations | 165,883 | 3,931 | 1,046 | - | 170,860 |
| Income from continuing operations before income taxes | \$153,773 | \$ 3,931 | \$ 1,046 | \$ - | \$158,750 |
| Income tax expense | (59,372) | (1,545) | (406) | (267) | (61,590) |
| Net income from continuing operations | \$94,401 | \$ 2,386 | \$ 640 | \$ (267) | \$97,160 |
| Diluted earnings per share from continuing operations | \$3.58 | \$ 0.09 | \$ 0.03 | \$ (0.01) | \$3.69 |
| Diluted share count | 26,337 | | | | |

Liquidity and Capital Resources

We manage our liquidity and capital resources to fund our operating, investing and financing activities. We rely primarily on cash flows from operations and borrowings under our credit facilities as the main sources for liquidity. We use those funds to invest in capital expenditures, increase working capital and fulfill contractual obligations. Remaining funds are used for acquisitions, debt retirement, cash dividends, share repurchases and general business purposes.

Available Sources

Below is a summary of our available funds (in thousands):

| | As of September | | Increase | % | |
|---|------------------------|-------------|-------------------|-------------------|---|
| | 30, | | | Increase | |
| | 2015 | 2014 | (Decrease) | (Decrease) | |
| Cash and cash equivalents | \$ 32,707 | \$ 21,666 | \$ 11,041 | 51.0 | % |
| Available credit on the credit facilities | 163,029 | 167,324 | (4,295) | (2.6 |) |
| Total current available funds | 195,736 | \$ 188,990 | 6,746 | 3.6 | |
| Estimated funds from unfinanced real estate | 108,607 | 99,847 | 8,760 | 8.8 | |
| Total estimated available funds | \$ 304,343 | \$ 288,837 | \$ 15,506 | 5.4 | % |

Cash flows generated by operating activities and from our credit facility are our most significant sources of liquidity. We also have the ability to raise funds through mortgaging real estate. As of September 30, 2015, our unencumbered owned operating real estate had a book value of \$143.4 million. Assuming we can obtain financing on 75% of this value, we estimate we could have obtained additional funds of approximately \$107.6 million at September 30, 2015; however, no assurances can be provided that the appraised value of these properties will match or exceed their book values or that this capital source will be available on terms acceptable to us.

In addition to the above sources of liquidity, potential sources include the placement of subordinated debentures or loans, the sale of equity securities and the sale of stores or other assets. We evaluate all of these options and may select one or more of them depending on overall capital needs and the availability and cost of capital, although no assurances can be provided that these capital sources will be available in sufficient amounts or with terms acceptable to us.

Information about our cash flows, by category, is presented in our Consolidated Statements of Cash Flows. The following table summarizes our cash flows (in thousands):

| | Nine Months Ended September 30, | | Increase (Decrease) |
|---|--|-------------|--------------------------------|
| | 2015 | 2014 | in Cash Flow |
| Net cash provided by operating activities | \$ 106,922 | \$ 87,702 | \$ 19,220 |
| Net cash used in investing activities | (104,577) | (122,350) | 17,773 |
| Net cash provided by financing activities | 464 | 32,628 | (32,164) |

Operating Activities

Cash provided by operating activities for the nine months ended September 30, 2015 compared to the same period of 2014 increased \$19.2 million, primarily as a result of increased profitability and improved trade receivables collections, partially offset by increased inventory purchases.

Borrowings from and repayments to our syndicated lending group related to our new vehicle inventory floor plan financing are presented as financing activities. To better understand the impact of changes in inventory and the associated financing, we also consider our net cash provided by operating activities adjusted to include cash activity associated with our new vehicle credit facility.

Adjusted net cash provided by operating activities is presented below (in thousands):

| (Dollars in thousands) | Nine Months Ended | | |
|--|--------------------------|-------------|-----------------|
| | September 30, | | Increase |
| | 2015 | 2014 | |
| Net cash provided by operating activities – as reported | \$ 106,922 | \$ 87,702 | \$ 19,220 |
| Add: Net borrowings on floor plan notes payable, non-trade | 36,204 | 30,375 | 5,829 |
| Net cash provided by operating activities – adjusted | \$ 143,126 | \$ 118,077 | \$ 25,049 |

Inventories are the most significant component of our cash flow from operations. As of September 30, 2015, our new vehicle days supply was 64, or two days higher than our days supply as of December 31, 2014. Our days supply of used vehicles was 54 days as of September 30, 2015, or one day higher than our days supply as of December 31, 2014. We calculate days supply of inventory based on current inventory levels, excluding in-transit vehicles, and a 30-day historical cost of sales level. We have continued to focus on managing our unit mix and maintaining an appropriate level of new and used vehicle inventory.

Investing Activities

Net cash used in investing activities totaled \$104.6 million and \$122.4 million, respectively, for the nine-month periods ended September 30, 2015 and 2014. Cash flows from investing activities relate primarily to capital expenditures, acquisition and divestiture activity and sales of property and equipment.

Below are highlights of significant activity related to our cash flows from investing activities (in thousands):

| | Nine Months Ended | | Increase (Decrease) |
|--|--------------------------|-------------|----------------------------|
| | September 30, | | |
| | 2015 | 2014 | in Cash Flow |
| Capital expenditures | \$(62,159) | \$(54,149) | \$ (8,010) |
| Cash paid for acquisitions, net of cash acquired | (34,920) | (81,558) | 46,638 |
| Cash paid for other investments | (20,693) | (3,385) | (17,308) |
| Proceeds from sales of stores | 12,966 | 10,617 | 2,349 |

Capital expenditures

Below is a summary of our capital expenditure activities:

| (Dollars in thousands) | Nine Months Ended | |
|---|-------------------------------|-------------|
| | September 30, 2015 | 2014 |
| Post-acquisition capital improvements | \$4,936 | \$11,928 |
| Facilities for open points | 3,338 | 3,820 |
| Purchases of previously leased facilities | 8,964 | 19,561 |
| Existing facility improvements | 26,610 | 10,296 |
| Maintenance | 18,311 | 8,544 |
| Total capital expenditures | \$62,159 | \$54,149 |

Many manufacturers provide assistance in the form of additional incentives or assistance if facilities meet manufacturer image standards and requirements. We expect that certain facility upgrades and remodels will generate additional manufacturer incentive payments.

We expect to use a portion of our future capital expenditures to upgrade facilities that we recently acquired. This additional capital investment is contemplated in our initial evaluation of the investment return metrics applied to each acquisition and is usually associated with manufacturer image standards and requirements.

We expect to make capital expenditures in 2015 of approximately \$100 million for capital improvements at recently acquired stores, purchases of land for expansion of existing stores, facility image improvements, purchases of store facilities, purchases of previously leased facilities and replacement of equipment.

Acquisitions

In the first nine months of 2015, we acquired four stores and added one franchise to one of our existing stores. We acquired seven stores and one franchise in the first nine months of 2014.

We focus on acquiring stores at opportunistic purchase prices that meet our return thresholds and strategic objectives. We look for acquisitions that diversify our brand and geographic mix as we continue to evaluate our portfolio to minimize exposure to any one manufacturer and achieve financial returns.

We evaluate potential capital investments based on certain criteria, primarily associated with targeted rates of return on assets and return on our net equity investment.

Other Investments

Our cash paid associated with other investments increased \$17.3 million in the nine months ended September 30, 2015 compared to the same period in 2014 mainly associated with our equity investment related to the NMTC Program.

Financing Activities

Net cash provided by financing activities totaled \$0.5 million and \$32.6 million, respectively, for nine-month periods ended September 30, 2015 and 2014.

Net cash (used in) provided by financing activities, adjusted for borrowing on floor plan facilities: non-trade was as follows (in thousands):

| Nine Months Ended | |
|-------------------------------|-------------|
| September 30, 2015 | 2014 |

Edgar Filing: LITHIA MOTORS INC - Form 10-Q

| | | |
|--|------------|----------|
| Cash provided by financing activities, as reported | \$464 | \$32,628 |
| Adjust: cash provided by borrowings on floor plan notes payable: non-trade | (36,204) | (30,375) |
| Cash (used in) provided by financing activities, as adjusted | \$(35,740) | \$2,253 |

Below are highlights of significant activity related to our cash flows from financing activities, excluding net borrowings on floor plan notes payable: non-trade, which are discussed above:

| (Dollars in thousands) | Nine Months Ended | | Decrease in Cash Flow |
|---|-----------------------|------------|-----------------------------|
| | September 30, 2015 | 2014 | |
| Net repayments on lines of credit | \$(61,477) | \$(54,844) | \$(6,633) |
| Proceeds from issuance of long-term debt | 75,675 | 76,530 | (855) |
| Principal payments on long-term debt, unscheduled | (9,189) | - | (9,189) |
| Repurchases of common stock | (24,198) | (11,745) | (12,453) |
| Dividends paid | (14,739) | (11,731) | (3,008) |

Borrowing and Repayment Activity

During the first nine months of 2015, we had net repayments of \$61.5 million associated with our lines of credit. We raised net mortgage proceeds of \$66.5 million during the first nine months of 2015, which were used to pay down our line of credit, increasing availability on our credit facility.

Our debt to total capital ratio, excluding floor plan notes payable, was 44.4% at September 30, 2015 compared to 30.4% at September 30, 2014. We partially funded our 2014 acquisition activity, including the DCH Auto Group acquisition, with additional debt.

Equity Transactions

Under the share repurchase program authorized by our Board of Directors and repurchases associated with stock compensation activity, we repurchased 242,433 shares of our Class A common stock at an average price of \$99.81 per share in the first nine months of 2015. As of September 30, 2015, we had 1,335,387 shares available for repurchase under our share repurchase program. The authority to repurchase does not have an expiration date.

In the first nine months of 2015, we declared and paid dividends on our Class A and Class B common stock as follows:

| Date | Dividend amount | Total amount of dividend |
|----------------------|------------------------|---------------------------------|
| dividend paid | per share | (in thousands) |
| March 2015 | \$ 0.16 | \$ 4,216 |
| May 2015 | 0.20 | 5,266 |
| August 2015 | 0.20 | 5,257 |

We evaluate performance and make a recommendation to the Board of Directors on dividend payments on a quarterly basis.

Summary of Outstanding Balances on Credit Facilities and Long-Term Debt

Below is a summary of our outstanding balances on credit facilities and long-term debt (in thousands):

| | |
|---------------------------|----------------------------|
| Outstanding | Remaining Available |
| as of | as of |
| September 30, 2015 | |

| | | September 30, 2015 | |
|---|--------------|-------------------------------|---------|
| Floor plan note payable: non-trade | \$ 1,168,223 | \$ - | (1) |
| Floor plan notes payable | 46,651 | - | |
| Used vehicle inventory financing facility | 166,000 | - | (2) |
| Revolving lines of credit | 41,292 | 163,029 | (2),(3) |
| Real estate mortgages | 391,728 | - | |
| Other debt | 30,956 | - | |
| Total debt | \$ 1,844,850 | \$ 163,029 | |

(1) As of September 30, 2015, we had a \$1.25 billion new vehicle floor plan commitment as part of our credit facility.

(2) The amount available on the credit facility is limited based on a borrowing base calculation and fluctuates monthly.

(3) Available credit is based on the borrowing base amount effective as of September 30, 2015. This amount is reduced by \$8.7 million for outstanding letters of credit.

Credit Facility

We have a \$1.7 billion revolving syndicated credit facility. This syndicated credit facility is comprised of 16 financial institutions, including seven manufacturer-affiliated finance companies. Our credit facility provides for up to \$1.25 billion in new vehicle inventory floor plan financing, up to \$200 million in used vehicle inventory floor plan financing and a maximum of \$250 million in revolving financing for general corporate purposes, including acquisitions and working capital. This credit facility may be expanded to \$1.85 billion total availability, subject to lender approval.

We may request a reallocation of any unused portion of our credit facility provided that the used vehicle inventory floor plan commitment does not exceed \$250 million, the revolving financing commitment does not exceed \$300 million, and the sum of those commitments plus the new vehicle inventory floor plan financing commitment does not exceed the total aggregate financing commitment. All borrowings from, and repayments to, our lending group are presented in the Consolidated Statements of Cash Flows as financing activities.

The new vehicle floor plan commitment is collateralized by our new vehicle inventory. Our used vehicle inventory financing facility is collateralized by our used vehicle inventory that has been in stock for less than 180 days. Our revolving line of credit is secured by our outstanding receivables related to vehicle sales, unencumbered vehicle inventory, other eligible receivables, parts and accessories and equipment.

We have the ability to deposit up to \$50 million in cash in Principal Reduction (PR) accounts associated with our new vehicle inventory floor plan commitment. The PR accounts are recognized as offsetting credits against outstanding amounts on our new vehicle floor plan commitment and would reduce interest expense associated with the outstanding principal balance. As of September 30, 2015, we had no balances in our PR accounts.

If the outstanding principal balance on our new vehicle inventory floor plan commitment, plus requests on any day, exceeds 95% of the loan commitment, a portion of the revolving line of credit must be reserved. The reserve amount is equal to the lesser of \$15.0 million or the maximum revolving line of credit commitment less the outstanding balance on the line less outstanding letters of credit. The reserve amount will decrease the revolving line of credit availability and may be used to repay the new vehicle floor plan commitment balance.

The interest rate on the credit facility varies based on the type of debt, with the rate of one-month LIBOR plus 1.25% for new vehicle floor plan financing, one-month LIBOR plus 1.50% for used vehicle floor plan financing; and a variable interest rate on the revolving financing ranging from the one-month LIBOR plus 1.25% to 2.50%, depending on our leverage ratio. The annual interest rate associated with our new vehicle floor plan commitment, excluding the effects of our interest rate swaps, was 1.4% at September 30, 2015. The annual interest rate associated with our used vehicle inventory financing facility and our revolving line of credit was 1.7% and 2.2%, respectively, at September 30, 2015.

Under the terms of our credit facility we are subject to financial covenants and restrictive covenants that limit or restrict our incurring additional indebtedness, making investments, selling or acquiring assets and granting security interests in our assets.

Under our credit facility, we are required to maintain the ratios detailed in the following table:

| Debt Covenant Ratio | Requirement | As of |
|-----------------------------|-----------------------------|-------------------------------|
| | | September 30, 2015 |
| Current ratio | Not less than 1.10 to 1 | 1.25 to 1 |
| Fixed charge coverage ratio | Not less than 1.20 to 1 | 3.38 to 1 |
| Leverage ratio | Not more than 5.00 to 1 | 1.84 to 1 |
| Funded debt restriction | Not to exceed \$600 million | \$424.0 million |

As of September 30, 2015, we were in compliance with all covenants. We expect to remain in compliance with the financial and restrictive covenants in our credit facility and other debt agreements. However, no assurances can be provided that we will continue to remain in compliance with the financial and restrictive covenants.

If we do not meet the financial and restrictive covenants and are unable to remediate or cure the condition or obtain a waiver from our lenders, a breach would give rise to remedies under the agreement, the most severe of which are the termination of the agreement, acceleration of the amounts owed and the seizure and sale of our assets comprising the collateral for the loans. A breach would also trigger cross-defaults under other debt agreements.

Floor Plan Notes Payable

We have floor plan agreements with manufacturer-affiliated finance companies for vehicles that are designated for use as service loaners. The variable interest rates on these floor plan notes payable commitments vary by manufacturer. At September 30, 2015, \$46.7 million was outstanding on these arrangements. Borrowings from, and repayments to, manufacturer-affiliated finance companies are classified as operating activities in the Consolidated Statements of Cash Flows.

Real Estate Mortgages and Other Debt

We have mortgages associated with our owned real estate. Interest rates related to this debt ranged from 1.8% to 5.0% at September 30, 2015. The mortgages are payable in various installments through October 2034. As of September 30, 2015, we had fixed interest rates on 80% of our outstanding mortgage debt.

Our other debt includes capital leases, sellers' notes and our equity contribution obligations associated with the new markets tax credit equity investment. The interest rates associated with our other debt ranged from 2.0% to 9.0% at September 30, 2015. This debt, which totaled \$30.9 million at September 30, 2015, is due in various installments through January 2024.

Recent Accounting Pronouncements

See Note 15 of the Condensed Notes to Consolidated Financial Statements in this Quarterly Report on Form 10-Q.

Critical Accounting Policies and Use of Estimates

There have been no material changes in the critical accounting policies and use of estimates described in our 2014 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 2, 2015.

Seasonality and Quarterly Fluctuations

Historically, our sales have been lower in the first and fourth quarters of each year due to consumer purchasing patterns during the holiday season, inclement weather in certain of our markets and the reduced number of business days during the holiday season. As a result, financial performance is expected to be lower during the first and fourth quarters than during the second and third quarters of each fiscal year. More recently, our franchise diversification and cost control efforts have moderated the significance of our seasonality. We believe that interest rates, levels of consumer debt, consumer confidence and manufacturer sales incentives, as well as general economic conditions, also contribute to fluctuations in sales and operating results.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements that have or are reasonably likely to have a material current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes in our reported market risks or risk management policies since the filing of our 2014 Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission on March 2, 2015.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We evaluated, with the participation and under the supervision of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure and that such information is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting that occurred during our last fiscal quarter that has materially affected or is reasonably likely to materially affect our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1A. Risk Factors

Except for the risk factors set forth below, there have been no material changes from the risk factors previously disclosed in our 2014 Annual Report on Form 10-K. The information in this Form 10-Q should be read in conjunction with the risk factors and information disclosed in that report, which was filed with the Securities and Exchange Commission on March 2, 2015.

We may not be able to utilize certain income tax benefits.

Our ability to utilize the income tax benefits and credits generated by our equity investments intended to generate new market tax credits (NMTC) depends on compliance with NMTC program requirements, which we do not control. Our ability to utilize NMTC, and other deferred tax assets, also depends on our generating sufficient taxable income from operations in the future. The inability to utilize the income tax benefits could have a material adverse impact on our business, results of operations, financial condition and cash flows.

Adverse conditions resulting from issues related to Volkswagen vehicle emissions may negatively impact our business, results of operations, financial condition and cash flows.

In September 2015, Volkswagen admitted utilizing software in certain diesel engine vehicles to detect when they were being emissions tested and to temporarily change performance to improve results. According to Automotive News, approximately 11 million vehicles built between 2009 and 2015 are affected and will be recalled and Volkswagen is potentially facing lawsuits and significant penalties from regulators worldwide. The current and future impact on Volkswagen's operations, consumer reputation and future vehicle demand is unclear, as is the effect on our business for the Volkswagen and Audi brands. Lithia currently operates five Volkswagen and three Audi stores, and approximately 3% of year to date 2015 and full year 2014 new vehicle unit sales were within these brands. Changes in demand for Volkswagen and Audi vehicles could significantly affect our business from those brands.

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

We repurchased the following shares of our Class A common stock during the third quarter of 2015:

| | Total number of shares purchased | Average price paid per share | Total number of shares purchased as part of publicly announced plan⁽¹⁾ | Maximum number of shares that may yet be purchased under the plans |
|-----------------------------|---|---|--|---|
| July 1 to July 31 | 23,900 | \$ 114.69 | 23,900 | 1,377,377 |
| August 1 to August 31 | 21,000 | 112.79 | 21,000 | 1,356,377 |
| September 1 to September 30 | 21,148 | 109.49 | 20,990 | 1,335,387 |
| Total | 66,048 | 112.42 | 65,890 | |

In 2011 and 2012, our Board of Directors authorized the repurchase of up to a total of 3,000,000 shares of our Class A common stock. Through September 30, 2015, we have repurchased 1,664,613 shares at an average price of (1) \$38.51 per share. This authority to repurchase shares does not have an expiration date or a maximum aggregate dollar amount for repurchases.

(2) Of the shares repurchased in September of 2015, 158 were related to the payment of taxes associated with the exercise of stock options or the vesting of restricted stock units.

Item 6. Exhibits

The following exhibits are filed herewith and this list is intended to constitute the exhibit index:

- 3.1 Restated Articles of Incorporation of Lithia Motors, Inc., as amended May 13, 1999 (incorporated by reference to exhibit 3.1 to our Form 10-K for the year ended December 31, 1999).
- 3.2 2013 Amended and Restated Bylaws of Lithia Motors, Inc. (incorporated by reference to exhibit 3.1 to Form 8-K dated August 20, 2013 and filed with the Securities and Exchange Commission on August 26, 2013).
- 10.1 Transition Agreement dated September 14, 2015 between Lithia Motors, Inc. and Sidney B. DeBoer (incorporated by reference to exhibit 10.1 to Form 8-K dated September 14, 2015 and filed with the Securities and Exchange Commission on September 17, 2015).
- 10.2 Director Service Agreement effective January 1, 2016 between Lithia Motors, Inc. and Sidney B. DeBoer (incorporated by reference to Exhibit 10.2 to Form 8-K dated September 14, 2015 and filed with the Securities and Exchange Commission on September 17, 2015).

Edgar Filing: LITHIA MOTORS INC - Form 10-Q

- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934.
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934.
- 32.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350.
- 32.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350.
- 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.

Date: October 30, 2015 LITHIA MOTORS, INC.

By: /s/ Christopher S. Holzshu

Christopher S. Holzshu

Senior Vice President,

Chief Financial Officer and Secretary

(Principal Financial Officer)

By: /s/ John F. North III

John F. North III

Vice President

(Principal Accounting Officer)