

SONIC AUTOMOTIVE INC
Form 10-Q
October 25, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2012

OR

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

Commission files number 1-13395

SONIC AUTOMOTIVE, INC.

(Exact name of registrant as specified in its charter)

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DELAWARE (State or other jurisdiction of incorporation or organization)	56-2010790 (I.R.S. Employer Identification No.)
4401 Colwick Road, Charlotte, North Carolina (Address of principal executive offices)	28211 (Zip Code)
(704) 566-2400 (Registrant's telephone number, including area code)	

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 website, 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 file). 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 definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act (check one).

Large Accelerated Filer Accelerated Filer

Non-Accelerated Filer (Do not check if a smaller reporting company) Smaller Reporting Company

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

As of October 17, 2012, there were 44,305,481 shares of Class A Common Stock and 12,029,375 shares of Class B Common Stock outstanding.

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Table of Contents**PART I - FINANCIAL INFORMATION****Item 1: Unaudited Condensed Consolidated Financial Statements.****SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(Dollars and shares in thousands, except per share amounts)

	Third Quarter Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenues:				
New vehicles	\$ 1,209,366	\$ 1,027,169	\$ 3,452,462	\$ 2,990,357
Used vehicles	534,028	509,751	1,581,682	1,489,098
Wholesale vehicles	53,088	47,137	140,670	122,261
Total vehicles	1,796,482	1,584,057	5,174,814	4,601,716
Parts, service and collision repair	290,897	287,105	885,412	857,541
Finance, insurance and other	64,867	54,974	187,199	157,175
Total revenues	2,152,246	1,926,136	6,247,425	5,616,432
Cost of Sales:				
New vehicles	(1,141,375)	(960,030)	(3,249,543)	(2,797,371)
Used vehicles	(497,927)	(476,057)	(1,469,639)	(1,380,618)
Wholesale vehicles	(56,532)	(49,332)	(145,163)	(126,636)
Total vehicles	(1,695,834)	(1,485,419)	(4,864,345)	(4,304,625)
Parts, service and collision repair	(148,753)	(147,333)	(452,712)	(436,263)
Total cost of sales	(1,844,587)	(1,632,752)	(5,317,057)	(4,740,888)
Gross profit	307,659	293,384	930,368	875,544
Selling, general and administrative expenses	(238,680)	(228,563)	(722,446)	(682,442)
Impairment charges	(23)	(102)	(57)	(160)
Depreciation and amortization	(11,375)	(10,137)	(33,636)	(29,457)
Operating income (loss)	57,581	54,582	174,229	163,485
Other income (expense):				
Interest expense, floor plan	(4,858)	(4,163)	(14,101)	(14,031)
Interest expense, other, net	(15,709)	(16,941)	(46,186)	(50,957)
Other income (expense), net	(17,275)	(811)	(19,808)	(741)
Total other income (expense)	(37,842)	(21,915)	(80,095)	(65,729)
Income (loss) from continuing operations before taxes	19,739	32,667	94,134	97,756
Provision for income taxes - benefit (expense)	(7,899)	(12,556)	(32,596)	(38,673)
Income (loss) from continuing operations	11,840	20,111	61,538	59,083
Discontinued operations:				
Income (loss) from operations and the sale of dealerships	(2,839)	(1,129)	(3,829)	(5,484)
Income tax benefit (expense)	1,041	419	1,010	2,117

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Income (loss) from discontinued operations	(1,798)	(710)	(2,819)	(3,367)
Net income (loss)	\$ 10,042	\$ 19,401	\$ 58,719	\$ 55,716
Basic earnings (loss) per common share:				
Earnings (loss) per share from continuing operations	\$ 0.21	\$ 0.38	\$ 1.14	\$ 1.11
Earnings (loss) per share from discontinued operations	(0.03)	(0.01)	(0.06)	(0.06)
Earnings (loss) per common share	\$ 0.18	\$ 0.37	\$ 1.08	\$ 1.05
Weighted average common shares outstanding	55,069	52,366	53,302	52,414
Diluted earnings (loss) per common share:				
Earnings (loss) per share from continuing operations	\$ 0.21	\$ 0.34	\$ 1.05	\$ 0.99
Earnings (loss) per share from discontinued operations	(0.03)	(0.01)	(0.05)	(0.05)
Earnings (loss) per common share	\$ 0.18	\$ 0.33	\$ 1.00	\$ 0.94
Weighted average common shares outstanding	59,011	65,517	62,300	65,800
Dividends declared per common share	\$ 0.025	\$ 0.025	\$ 0.075	\$ 0.075

See notes to Unaudited Condensed Consolidated Financial Statements.

Table of Contents**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(Dollars in thousands)**

	Third Quarter Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income (loss)	\$ 10,042	\$ 19,401	\$ 58,719	\$ 55,716
Other comprehensive income (loss) before taxes:				
Change in fair value of interest rate swap agreements	(194)	(4,239)	(133)	(5,902)
Total other comprehensive income (loss) before taxes	(194)	(4,239)	(133)	(5,902)
Provision for income tax benefit (expense) related to components of other comprehensive income (loss)	72	1,611	50	2,242
Other comprehensive income (loss)	(122)	(2,628)	(83)	(3,660)
Comprehensive income (loss)	\$ 9,920	\$ 16,773	\$ 58,636	\$ 52,056

See notes to Unaudited Condensed Consolidated Financial Statements.

Table of Contents**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**

(Dollars in thousands)

	September 30, 2012	December 31, 2011
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 62,477	\$ 1,913
Receivables, net	240,664	303,279
Inventories	1,033,290	863,133
Other current assets	18,763	12,404
Total current assets	1,355,194	1,180,729
Property and Equipment, net	567,929	552,037
Goodwill	458,969	468,465
Other Intangible Assets, net	73,710	76,276
Other Assets	47,559	62,122
Total Assets	\$ 2,503,361	\$ 2,339,629
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Notes payable - floor plan - trade	\$ 556,570	\$ 469,027
Notes payable - floor plan - non-trade	413,284	399,314
Trade accounts payable	67,302	86,902
Accrued interest	8,251	12,117
Other accrued liabilities	166,504	177,707
Current maturities of long-term debt	12,289	11,608
Total current liabilities	1,224,200	1,156,675
Long-Term Debt	598,890	536,011
Other Long-Term Liabilities	121,149	124,201
Commitments and Contingencies		
Stockholders Equity:		
Class A convertible preferred stock, none issued		
Class A common stock, \$0.01 par value; 100,000,000 shares authorized; 61,191,866 shares issued and 44,504,087 shares outstanding at September 30, 2012; 56,377,778 shares issued and 40,600,031 shares outstanding at December 31, 2011	612	564
Class B common stock; \$0.01 par value; 30,000,000 shares authorized; 12,029,375 shares issued and outstanding at September 30, 2012 and December 31, 2011	121	121
Paid-in capital	666,000	667,839
Retained earnings	179,008	124,383
Accumulated other comprehensive income (loss)	(21,573)	(21,490)
Treasury stock, at cost (16,687,779 Class A shares held at September 30, 2012 and 15,777,747 Class A shares held at December 31, 2011)	(265,046)	(248,675)
Total stockholders equity	559,122	522,742
Total Liabilities and Stockholders Equity	\$ 2,503,361	\$ 2,339,629

See notes to Unaudited Condensed Consolidated Financial Statements.

Table of Contents**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****UNAUDITED CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY**

(Dollars and shares in thousands)

	Class A Common Stock		Class B Common Stock		Paid-In Capital	Retained Earnings / (Accumulated Deficit)	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
	Shares	Amount	Shares	Amount					
BALANCE AT DECEMBER 31, 2011	56,378	\$ 564	12,029	\$ 121	\$ 667,839	\$ 124,383	\$ (248,675)	\$ (21,490)	\$ 522,742
Shares awarded under stock compensation plans	448	4			1,484				1,488
Issuance of common stock	4,075	41			67,495				67,536
Purchases of treasury stock							(16,371)		(16,371)
Income tax benefit associated with stock compensation plans					1,939				1,939
Derecognition of equity component of 5.0% Convertible Notes (1), net of tax expense of \$662					(76,701)				(76,701)
Fair value of interest rate swap agreements, net of tax benefit of \$50								(83)	(83)
Stock-based compensation expense					122				122
Restricted stock amortization					3,825				3,825
Other	291	3			(3)				
Net income (loss)						58,719			58,719
Dividends (\$0.075 per share)						(4,094)			(4,094)
BALANCE AT SEPTEMBER 30, 2012	61,192	\$ 612	12,029	\$ 121	\$ 666,000	\$ 179,008	\$ (265,046)	\$ (21,573)	\$ 559,122

(1) 5.0% Convertible Senior Notes due 2029 which were extinguished during the third quarter ended September 30, 2012 (the 5.0% Convertible Notes). See Note 6, Long-Term Debt, for further discussion.

See notes to Unaudited Condensed Consolidated Financial Statements.

Table of Contents**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Dollars in thousands)

	Nine Months Ended September 30,	
	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	\$ 58,719	\$ 55,716
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization of property, plant and equipment	34,017	30,041
Provision for bad debt expense	347	483
Other amortization	1,170	1,246
Debt issuance cost amortization	2,279	2,992
Debt discount amortization, net of premium amortization	2,812	3,911
Stock - based compensation expense	122	327
Amortization of restricted stock, net of forfeitures	3,825	2,348
Deferred income taxes	14,414	(1,280)
Equity interest in earnings of investees	(369)	(462)
Asset impairment charges	57	160
Loss (gain) on disposal of dealerships and property and equipment	(6,855)	243
Loss on exit of leased dealerships	3,462	4,195
(Gain) loss on retirement of debt	19,898	831
Non-cash adjustments - cash flow swaps	(494)	599
Changes in assets and liabilities that relate to operations:		
Receivables	62,642	38,789
Inventories	(195,212)	87,744
Other assets	(9,550)	(6,188)
Notes payable - floor plan - trade	87,543	(53,640)
Trade accounts payable and other liabilities	(43,477)	(710)
Total adjustments	(23,369)	111,629
Net cash provided by (used in) operating activities	35,350	167,345
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of land, property and equipment	(55,224)	(135,897)
Proceeds from sales of property and equipment	(873)	653
Proceeds from sales of dealerships	51,853	129
Distributions from equity investees	700	600
Net cash provided by (used in) investing activities	(3,544)	(134,515)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net (repayments) borrowings on notes payable floor plan - non-trade	13,970	(50,528)
Borrowings on revolving credit facilities	105,894	228,002
Repayments on revolving credit facilities	(105,894)	(210,002)
Proceeds from issuance of long-term debt	208,920	61,470
Debt issuance costs	(4,472)	
Principal payments on long-term debt	(7,831)	(17,939)
Repurchase of debt securities	(164,896)	(52,585)
Purchases of treasury stock	(16,371)	(9,112)

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Income tax benefit (expense) associated with stock compensation plans	1,939	1,143
Issuance of shares under stock compensation plans	1,488	524
Dividends paid	(3,989)	(3,969)
Net cash provided by (used in) financing activities	28,758	(52,996)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	60,564	(20,166)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	1,913	21,842
CASH AND CASH EQUIVALENTS, END OF YEAR	\$ 62,477	\$ 1,676

SUPPLEMENTAL SCHEDULE OF NON-CASH FINANCING ACTIVITIES:

Change in fair value of cash flow hedging instruments (net of tax benefit of \$50 and \$2,242 in the nine-month periods ended September 30, 2012 and 2011, respectively)	\$ (83)	\$ (3,660)
Issuance of common stock as consideration for extinguishment of debt securities	\$ (67,869)	\$

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Cash paid (received) during the year for:

Interest, including amount capitalized	\$ 64,542	\$ 69,973
Income taxes	\$ 25,749	\$ 18,982

See notes to Unaudited Condensed Consolidated Financial Statements.

Table of Contents**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****1. Summary of Significant Accounting Policies**

Basis of Presentation The accompanying Unaudited Condensed Consolidated Financial Statements for the third quarter and nine-month periods ended September 30, 2012 and 2011 have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and applicable rules and regulations of the Securities and Exchange Commission (the SEC). All material intercompany accounts and transactions have been eliminated. These Unaudited Condensed Consolidated Financial Statements reflect, in the opinion of management, all material normal recurring adjustments necessary to fairly state the financial position and the results of operations for the periods presented. The results for interim periods are not necessarily indicative of the results to be expected for the entire fiscal year. These interim financial statements should be read in conjunction with the audited Consolidated Financial Statements of Sonic Automotive, Inc. (Sonic or the Company) for the year ended December 31, 2011, which were included in Sonic's Annual Report on Form 10-K and updated in Sonic's Current Report on Form 8-K furnished to the SEC pursuant to Items 2.02 and 9.01 on June 25, 2012.

Reclassifications The Unaudited Condensed Consolidated Statements of Income for the third quarter and nine-month periods ended September 30, 2011 reflect the reclassification of balances from continuing operations to discontinued operations from the prior year presentation for additional dealerships sold or terminated subsequent to September 30, 2011.

Recent Accounting Pronouncements In May 2011, the Financial Accounting Standards Board (the FASB) issued an accounting standard update that amends the accounting standard on fair value measurements. The accounting standard update provides for a consistent definition and measurement of fair value, as well as similar disclosure requirements between U.S. Generally Accepted Accounting Principles and International Financial Reporting Standards. The accounting standard update changes certain fair value measurement principles, clarifies the application of existing fair value measurement, and expands the fair value measurement disclosure requirements, particularly for Level 3 fair value measurements. The amendments in this accounting standard update are to be applied prospectively and are effective for interim and annual periods beginning after December 15, 2011. The adoption of this accounting standard did not have a material effect on Sonic's consolidated financial statements or disclosures.

Lease Exit Accruals Lease exit accruals relate to facilities Sonic has ceased using in its operations. The accruals represent the present value of the lease payments, net of estimated or actual sublease proceeds, for the remaining life of the operating leases and other accruals necessary to satisfy the lease commitment to the landlord.

A summary of the activity of these lease exit accruals consists of the following:

	(In thousands)
Balance, December 31, 2011	\$ 39,118
Lease exit expense (1)	3,462
Payments (2)	(6,572)
Lease buyout (3)	(1,657)
Balance, September 30, 2012	\$ 34,351

- Expense of approximately \$0.3 million is recorded in interest expense, other, net, a benefit of approximately \$0.4 million is recorded in selling, general and administrative expenses and expense of approximately \$3.6 million is recorded to income (loss) from operations and the sale of dealerships in the accompanying Unaudited Condensed Consolidated Statements of Income.
- Amount is recorded as reduction of rent expense in selling, general and administrative expenses, with approximately \$1.0 million in continuing operations and \$5.6 million as a reduction to income (loss) from operations and the sale of dealerships in the accompanying Unaudited Condensed Consolidated Statements of Income.
- Amount represents write-off of accrual related to an early lease buyout agreement which was completed and paid, relieving Sonic of any future lease obligation.

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Income Tax Expense The overall effective tax rate from continuing operations was 40.0% and 34.6% for the third quarter and nine-month periods ended September 30, 2012, respectively, and 38.4% and 39.6% for the third quarter and nine-month periods ended September 30, 2011, respectively. The effective rate for the third quarter ended September 30, 2012 was higher than the same prior year period due to the level of overall taxable income and the shift in the distribution of taxable income between states in which Sonic operates. The effective rate for the nine-month period ended September 30, 2012 was lower than the same prior year period primarily due to a \$3.6 million tax benefit during the second quarter ended June 30, 2012 related to the settlement of a state tax examination.

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Dispositions The operating results of disposed dealerships are included in the income (loss) from discontinued operations in Sonic's Unaudited Condensed Consolidated Statements of Income. During the third quarter ended September 30, 2012, Sonic disposed of three dealerships, which generated cash from disposition of approximately \$28.3 million on the disposal of approximately \$13.6 million of net assets. During the nine-month period ended September 30, 2012, Sonic disposed of eight dealerships, which generated cash from disposition of approximately \$51.9 million on the disposal of approximately \$21.6 million of net assets. At September 30, 2012, there were no dealerships held for sale.

Revenues and other activities associated with franchises classified as discontinued operations were as follows:

(In thousands)	Third Quarter Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Income (loss) from operations	\$ (1,607)	\$ (1,646)	\$ (6,832)	\$ (4,906)
Gain (loss) on disposal	1,084	(136)	6,597	(358)
Lease exit accrual adjustments and charges	(2,316)	653	(3,594)	(220)
Pre-tax income (loss)	\$ (2,839)	\$ (1,129)	\$ (3,829)	\$ (5,484)
Total revenues	\$ 21,198	\$ 66,689	\$ 109,359	\$ 183,960

Lease exit charges recorded during the third quarter and nine-month periods ended September 30, 2012 and 2011 relate to interest charges, the revision of estimates on previously established lease exit accruals and the reversal of a lease exit accrual related to a property which was returned to operating use. The lease exit accruals represent the present value of the lease payments, net of estimated or actual sublease proceeds, for the remaining life of the operating leases and other accruals necessary to satisfy the lease commitment to the landlord.

3. Inventories

Inventories consist of the following:

(In thousands)	September 30, 2012	December 31, 2011
New vehicles	\$ 758,572	\$ 569,573
Used vehicles	150,958	178,568
Parts and accessories	52,273	54,042
Other	71,487	60,950
Inventories	\$ 1,033,290	\$ 863,133

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Property and equipment consists of the following:

(In thousands)	September 30, 2012	December 31, 2011
Land	\$ 134,407	\$ 131,865
Building and improvements	459,757	455,650
Office equipment and fixtures	111,406	92,920
Parts and service equipment	61,270	61,561
Company vehicles	8,027	8,391
Construction in progress	33,929	16,191
Total, at cost	808,796	766,578
Less accumulated depreciation	(240,867)	(214,541)
Property and equipment, net	\$ 567,929	\$ 552,037

In the third quarter and nine-month periods ended September 30, 2012, capital expenditures were approximately \$20.7 million and \$55.2 million, respectively, and were primarily related to construction of new dealerships, building improvements and equipment purchased for use in Sonic's dealerships.

5. Goodwill and Intangible Assets

(In thousands)	Franchise Agreements	Gross Goodwill	Accumulated Impairment	Net Goodwill
Balance, December 31, 2011	\$ 64,835	\$ 1,265,190	\$ (796,725)	\$ 468,465
Reductions from dispositions	(1,400)	(12,256)	2,759	(9,496)
Balance, September 30, 2012	\$ 63,435	\$ 1,252,934	\$ (793,966)	\$ 458,969

At December 31, 2011, Sonic had approximately \$11.4 million of definite life intangibles recorded related to favorable lease agreements. After the effect of amortization of the definite life intangibles, the balance recorded at September 30, 2012 was approximately \$10.3 million and was included in other intangible assets, net, in the accompanying Unaudited Condensed Consolidated Balance Sheets.

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Long-term debt consists of the following:

(In thousands)	September 30, 2012	December 31, 2011
2011 Revolving Credit Facility (1)	\$	\$
9.0% Senior Subordinated Notes due 2018 (the 9.0% Notes)	210,000	210,000
7.0% Senior Subordinated Notes due 2022 (the 7.0% Notes)	200,000	
5.0% Convertible Senior Notes due 2029, redeemable in 2014 (the 5.0% Convertible Notes) (2)		155,055
Notes payable to a finance company bearing interest from 9.52% to 10.52% (with a weighted average of 10.19%)	11,262	13,223
Mortgage notes to finance companies-fixed rate, bearing interest from 4.29% to 7.03%	124,132	116,584
Mortgage notes to finance companies-variable rate, bearing interest at 1.25 to 3.50 percentage points above one-month LIBOR	63,082	65,640
Net debt discount and premium (3)	(2,810)	(18,635)
Other	5,513	5,752
Total debt	\$ 611,179	\$ 547,619
Less current maturities	(12,289)	(11,608)
Long-term debt	\$ 598,890	\$ 536,011

- (1) The interest rate on the revolving credit facility was 2.0% above LIBOR at September 30, 2012 and 2.25% above LIBOR at December 31, 2011.
- (2) See the heading 5.0% Senior Convertible Notes below for further discussion.
- (3) September 30, 2012 includes \$1.1 million discount associated with the 9.0% Notes, \$1.7 million discount associated with the 7.0% Notes, \$0.8 million premium associated with notes payable to a finance company and and \$0.8 million discount associated with mortgage notes payable. December 31, 2011 includes \$1.2 million discount associated with the 9.0% Notes, \$17.7 million discount associated with the 5.0% Convertible Notes, \$1.2 million premium associated with notes payable to a finance company and \$0.9 million discount associated with mortgage notes payable.

2011 Credit Facilities

Sonic has a syndicated revolving credit agreement (the 2011 Revolving Credit Facility) and a syndicated floor plan credit facility (the 2011 Floor Plan Facility). The 2011 Revolving Credit Facility and 2011 Floor Plan Facility (collectively the 2011 Credit Facilities) are scheduled to mature on August 15, 2016.

Availability under the 2011 Revolving Credit Facility is calculated as the lesser of \$175.0 million or a borrowing base calculated based on certain eligible assets plus 50% of the fair market value of 5,000,000 shares of common stock of Speedway Motorsports, Inc. (SMI) that are pledged as collateral, less the aggregate face amount of any outstanding letters of credit under the 2011 Revolving Credit Facility (the 2011 Revolving Borrowing Base). The 2011 Revolving Credit Facility may be increased at Sonic s option to \$225.0 million upon satisfaction of certain conditions. A withdrawal of the pledge of SMI common stock by Sonic Financial Corporation (SFC), which holds the 5,000,000 shares of common stock of SMI, or a decline in the value of SMI common stock, could reduce the amount Sonic can borrow under the 2011 Revolving Credit Facility.

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Based on balances as of September 30, 2012, the 2011 Revolving Borrowing Base was approximately \$165.0 million and Sonic had approximately \$38.7 million in outstanding letters of credit resulting in total borrowing availability of approximately \$126.3 million under the 2011 Revolving Credit Facility.

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Sonic was in compliance with the covenants under the 2011 Credit Facilities as of September 30, 2012. Financial covenants include required specified ratios (as each is defined in the 2011 Credit Facilities) of:

	Minimum Consolidated Liquidity Ratio	Covenant Minimum Consolidated Fixed Charge Coverage Ratio	Maximum Consolidated Total Lease Adjusted Leverage Ratio
Required ratio	1.05	1.20	5.50
September 30, 2012 actual	1.21	1.66	4.01

The 2011 Credit Facilities contain events of default, including cross-defaults to other material indebtedness, change of control events and events of default customary for syndicated commercial credit facilities. Upon the future occurrence of an event of default, Sonic could be required to immediately repay all outstanding amounts under the 2011 Credit Facilities.

In addition, many of Sonic's facility leases are governed by a guarantee agreement between the landlord and Sonic that contains financial and operating covenants. The financial covenants are identical to those under the 2011 Credit Facilities with the exception of one financial covenant related to the ratio of EBTDAR to Rent (as defined in the lease agreements) with a required ratio of no less than 1.50 to 1.00. At September 30, 2012, the ratio was 3.00 to 1.00.

9.0% Senior Subordinated Notes

The 9.0% Notes are unsecured senior subordinated obligations of Sonic that mature on March 15, 2018 and are guaranteed by Sonic's domestic operating subsidiaries. Interest is payable semi-annually on March 15 and September 15 each year. Sonic may redeem the 9.0% Notes in whole or in part at any time after March 15, 2014 at the following redemption prices, which are expressed as percentages of the principal amount:

	Redemption Price
Beginning on March 15, 2014	104.50%
Beginning on March 15, 2015	102.25%
Beginning on March 15, 2016 and thereafter	100.00%

In addition, on or before March 15, 2013, Sonic may redeem up to 35% of the aggregate principal amount of the 9.0% Notes at par value plus accrued interest with proceeds from certain equity offerings. The Indenture also provides that holders of 9.0% Notes may require Sonic to repurchase the 9.0% Notes at 101% of the par value of the 9.0% Notes, plus accrued interest if Sonic undergoes a change of control as defined in the Indenture.

The Indenture governing the 9.0% Notes contains certain specified restrictive covenants. Sonic has agreed not to pledge any assets to any third party lender of senior subordinated debt except under certain limited circumstances. Sonic also has agreed to certain other limitations or prohibitions concerning the incurrence of other indebtedness, capital stock, guarantees, asset sales, investments, cash dividends to stockholders, distributions and redemptions. Specifically, the indenture governing Sonic's 9.0% Notes limits Sonic's ability to pay quarterly cash dividends on Sonic's Class A and B common stock in excess of \$0.10 per share. Sonic may only pay quarterly cash dividends on Sonic's Class A and B common stock if Sonic complies with the terms of the indenture governing the 9.0% Notes. Sonic was in compliance with all restrictive covenants as of September 30, 2012.

7.0% Senior Subordinated Notes

On July 2, 2012, Sonic issued \$200.0 million in aggregate principal amount of 7.0% Senior Subordinated Notes which mature on July 15, 2022 (the 7.0% Notes). The 7.0% Notes were issued at a price of 99.11% of the principal amount thereof (the Issue Price), resulting in a yield to maturity of 7.125%. Sonic used the net proceeds from the issuance of the

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7.0% Notes and issued 4,074,905 shares of its Class A common stock to repurchase all of its outstanding 5.0% Convertible Notes pursuant to an exchange offer (see the heading "5.0% Convertible Senior Notes" below for further discussion). Remaining proceeds from the issuance of the 7.0% Notes will be used for general corporate purposes, including repurchases of shares of Sonic's Class A common stock. The 7.0% Notes are unsecured senior subordinated obligations of Sonic and are guaranteed by Sonic's domestic operating subsidiaries. Interest is payable semi-annually in arrears on January 15 and July 15 of each year, beginning on January 15, 2013.

Sonic may redeem the 7.0% Notes in whole or in part at any time after July 15, 2017 at the following redemption prices, which are expressed as percentages of the principal amount:

	Redemption Price
Beginning on July 15, 2017	103.500%
Beginning on July 15, 2018	102.333%
Beginning on July 15, 2019	101.167%
Beginning on July 15, 2020 and thereafter	100.000%

In addition, on or before July 15, 2015, Sonic may redeem up to 35% of the aggregate principal amount of the 7.0% Notes at 107% of the par value of the 7.0% Notes plus accrued and unpaid interest with proceeds from certain equity offerings. The indenture also provides that holders of the 7.0% Notes may require Sonic to repurchase the 7.0% Notes at 101% of the par value of the 7.0% Notes, plus accrued and unpaid interest, if Sonic undergoes a change of control as defined in the indenture.

The indenture governing the 7.0% Notes contains certain specified restrictive covenants. Sonic has agreed not to pledge any assets to any third party lender of senior subordinated debt except under certain limited circumstances. Sonic also has agreed to certain other limitations or prohibitions concerning the incurrence of other indebtedness, guarantees, liens, certain types of investments, certain transactions with affiliates, mergers, consolidations, issuance of preferred stock, cash dividends to stockholders, distributions, redemptions and the sale, assignment, lease, conveyance or disposal of certain assets. Specifically, the indenture governing Sonic's 7.0% Notes limits Sonic's ability to pay quarterly cash dividends on Sonic's Class A and B common stock in excess of \$0.10 per share. Sonic may only pay quarterly cash dividends on Sonic's Class A and B common stock if Sonic complies with the terms of the indenture governing the 7.0% Notes.

Balances outstanding under Sonic's 7.0% Notes are guaranteed by all of Sonic's operating domestic subsidiaries. These guarantees are full and unconditional and joint and several. The parent company has no independent assets or operations. The non-domestic and non-operating subsidiaries that are not guarantors are considered to be minor.

Sonic's obligations under the 7.0% Notes may be accelerated by the holders of 25% of the outstanding principal amount of the 7.0% Notes then outstanding if certain events of default occur, including: (1) defaults in the payment of principal or interest when due; (2) defaults in the performance, or breach, of Sonic's covenants under the 7.0% Notes; and (3) certain defaults under other agreements under which Sonic or its subsidiaries have outstanding indebtedness in excess of \$35.0 million.

5.0% Convertible Senior Notes

During the third quarter ended September 30, 2012, Sonic repurchased all of its outstanding 5.0% Convertible Notes through an offer to exchange newly issued shares of Class A common stock and cash from the issuance of the 7.0% Notes. On July 27, 2012, Sonic finalized an offer to exchange newly issued shares of Class A common stock and cash for all of its outstanding 5.0% Convertible Notes as described in Sonic's Registration Statement on Form S-4 (Reg. No. 333-182307). The final offer consideration per \$1,000 principal amount of the 5.0% Convertible Notes was \$1,503.11, and was paid by (i) a fixed cash payment of \$1,000 plus (ii) 30,2070 shares of Sonic's Class A common stock, which was the number of shares determined by a volume weighted average pricing (VWAP) formula described in Sonic's Registration Statement on Form S-4 (Reg. No. 333-182307). In addition, holders received, in respect of their 5.0% Convertible Notes that were accepted for exchange, accrued and unpaid interest on such notes up to, but excluding, the settlement date of the offer. Cash was paid in lieu of fractional shares based on the VWAP. In total, Sonic paid approximately \$137.1 million in cash (including accrued and unpaid interest on the 5.0% Convertible Notes

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and cash paid in lieu of fractional shares) and issued 4,074,905 shares of Class A common stock as consideration for the extinguishment of all of its outstanding 5.0% Convertible Notes. Refer to the accompanying Unaudited Condensed Consolidated Statement of Stockholders' Equity for the impact of this stock issuance on total equity.

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SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

In addition to the issuance of Class A common stock discussed above, during the third quarter and nine-month periods ended September 30, 2012, Sonic incurred costs of approximately \$18.5 million and \$21.1 million, respectively, related to the repurchases of the 5.0% Convertible Notes. Approximately \$1.2 million of the charge in the third quarter and nine-month periods ended September 30, 2012 is recorded in interest, expense, other, net, related to the incremental interest incurred while both the 5.0% Convertible Notes and the 7.0% Notes were outstanding, and the remainder is related to the loss on extinguishment and is recorded in other income (expense), net, in the accompanying Unaudited Condensed Consolidated Statements of Income.

Sonic incurred interest expense related to the 5.0% Convertible Notes of approximately \$0.5 million and \$4.2 million for the third quarter and nine-month periods ended September 30, 2012, respectively, and approximately \$2.1 million and \$6.4 million for the third quarter and nine-month periods ended September 30, 2011, respectively, recorded to interest expense, other, net, in the accompanying Unaudited Condensed Consolidated Statements of Income. In addition, Sonic recorded interest expense associated with the amortization of debt discount and deferred loan costs on the 5.0% Convertible Notes of approximately \$0.5 million and \$3.5 million for the third quarter and nine-month periods ended September 30, 2012, respectively, and approximately \$1.7 million and \$5.2 million for the third quarter and nine-month periods ended September 30, 2011, respectively, recorded to interest expense, other, net, in the accompanying Unaudited Condensed Consolidated Statements of Income.

Mortgage Notes

Sonic has mortgage financing totaling approximately \$187.2 million in aggregate, related to 20 of its dealership properties. These mortgage notes require monthly payments of principal and interest through maturity and are secured by the underlying properties. Maturity dates range between June 2013 and March 2031. The weighted average interest rate was 4.66% at September 30, 2012.

Table of Contents**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS***Derivative Instruments and Hedging Activities*

Sonic has interest rate cash flow swap agreements to effectively convert a portion of its LIBOR-based variable rate debt to a fixed rate. The fair value of these swap positions at September 30, 2012 was a liability of approximately \$37.3 million, with \$12.3 million included in other accrued liabilities and \$25.0 million included in other long-term liabilities in the accompanying Unaudited Condensed Consolidated Balance Sheets. Under the terms of these cash flow swaps, Sonic will receive and pay interest based on the following:

Notional Amount (In millions)	Pay Rate	Receive Rate (1)	Maturing Date
\$ 3.2	7.100%	one-month LIBOR + 1.50%	July 10, 2017
\$ 25.0 (2)	4.885%	one-month LIBOR	October 1, 2012
\$ 10.1	4.655%	one-month LIBOR	December 10, 2017
\$ 8.2 (2)	6.860%	one-month LIBOR + 1.25%	August 1, 2017
\$ 6.2	4.330%	one-month LIBOR	July 1, 2013
\$ 100.0	3.280%	one-month LIBOR	July 1, 2015
\$ 100.0	3.300%	one-month LIBOR	July 1, 2015
\$ 6.9 (2)	6.410%	one-month LIBOR + 1.25%	September 12, 2017
\$ 50.0	2.767%	one-month LIBOR	July 1, 2014
\$ 50.0	3.240%	one-month LIBOR	July 1, 2015
\$ 50.0	2.610%	one-month LIBOR	July 1, 2014
\$ 50.0	3.070%	one-month LIBOR	July 1, 2015
\$ 100.0 (3)	2.065%	one-month LIBOR	June 30, 2017
\$ 100.0 (3)	2.015%	one-month LIBOR	June 30, 2017

(1) The one-month LIBOR rate was 0.214% at September 30, 2012.

(2) Changes in fair value are recorded through earnings.

(3) The effective date of these forward-starting swaps is July 1, 2015.

During the nine-month period ended September 30, 2012, Sonic entered into two \$100.0 million notional forward-starting interest rate cash flow swap agreements that become effective in July 2015 and terminate in June 2017. These interest rate swaps have been designated and qualify as cash flow hedges and, as a result, changes in the fair value of these swaps are recorded in other comprehensive income (loss), net of related income taxes, in the accompanying Unaudited Condensed Consolidated Statements of Comprehensive Income.

For the cash flow swaps not designated as hedges (changes in the fair value are recognized through earnings) and amortization of amounts in accumulated other comprehensive income (loss) related to terminated cash flow swaps, certain benefits and charges were included in interest expense, other, net, in the accompanying Unaudited Condensed Consolidated Statements of Income.

For the cash flow swaps that qualify as cash flow hedges, the changes in the fair value of these swaps have been recorded in other comprehensive income (loss), net of related income taxes, in the accompanying Unaudited Condensed Consolidated Statements of Comprehensive Income. The incremental interest expense (the difference between interest paid and interest received) related to these cash flow swaps was approximately \$3.4 million and \$10.3 million for the third quarter and nine-month periods ended September 30, 2012, respectively, and \$4.5 million and \$13.3 million for the third quarter and nine-month periods ended September 30, 2011, respectively, and is included in interest expense, other, net, in the accompanying Unaudited Condensed Consolidated Statements of Income. The estimated net expense expected to be reclassified out of accumulated other comprehensive income (loss) into results of operations during the next twelve months is approximately \$7.6 million.

Table of Contents**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****7. Per Share Data and Stockholders' Equity**

The calculation of diluted earnings per share considers the potential dilutive effect of options and shares under Sonic's stock compensation plans, Class A common stock purchase warrants and the 5.0% Convertible Notes. Sonic's non-vested restricted stock and restricted stock units contain rights to receive non-forfeitable dividends, and thus, are considered participating securities and are included in the two-class method of computing earnings per share. The following table illustrates the dilutive effect of such items on earnings per share for the third quarter and nine-month periods ended September 30, 2012 and 2011:

	Weighted Average Shares	Third Quarter Ended September 30, 2012					
		Income (Loss) From Continuing Operations		Income (Loss) From Discontinued Operations		Net Income (Loss)	
		Per Share		Per Share		Per Share	
		Amount	Amount	Amount	Amount	Amount	Amount
Earnings (loss) and shares	55,069	\$ 11,840	\$ 0.21	\$ (1,798)	\$ (0.03)	\$ 10,042	\$ 0.18
Effect of participating securities:							
Non-vested restricted stock and stock units		(175)				(175)	
Basic earnings (loss) and shares	55,069	\$ 11,665	\$ 0.21	\$ (1,798)	\$ (0.03)	\$ 9,867	\$ 0.18
Effect of dilutive securities:							
Contingently convertible debt (5.0% Convertible Notes)	3,534	618		2		620	
Stock compensation plans	408						
Diluted earnings (loss) and shares	59,011	\$ 12,283	\$ 0.21	\$ (1,796)	\$ (0.03)	\$ 10,487	\$ 0.18

	Weighted Average Shares	Third Quarter Ended September 30, 2011					
		Income (Loss) From Continuing Operations		Income (Loss) From Discontinued Operations		Net Income (Loss)	
		Per Share		Per Share		Per Share	
		Amount	Amount	Amount	Amount	Amount	Amount
Earnings (loss) and shares	52,366	\$ 20,111	\$ 0.38	\$ (710)	\$ (0.01)	\$ 19,401	\$ 0.37
Effect of participating securities:							
Non-vested restricted stock and stock units		(263)				(263)	
Basic earnings (loss) and shares	52,366	\$ 19,848	\$ 0.38	\$ (710)	\$ (0.01)	\$ 19,138	\$ 0.37
Effect of dilutive securities:							
Contingently convertible debt (5.0% Convertible Notes)	12,590	2,329		37		2,366	
Stock compensation plans	561						
Diluted earnings (loss) and shares	65,517	\$ 22,177	\$ 0.34	\$ (673)	\$ (0.01)	\$ 21,504	\$ 0.33

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	Weighted Average Shares	Nine Months Ended September 30, 2012					
		Income (Loss) From Continuing Operations		Income (Loss) From Discontinued Operations		Net Income (Loss)	
		Amount	Per Share	Amount	Per Share	Amount	Per Share
			Amount		Amount		Amount
Earnings (loss) and shares	53,302	\$ 61,538		\$ (2,819)		\$ 58,719	
Effect of participating securities:							
Non-vested restricted stock and stock units		(934)				(934)	
Basic earnings (loss) and shares	53,302	\$ 60,604	\$ 1.14	\$ (2,819)	\$ (0.06)	\$ 57,785	\$ 1.08
Effect of dilutive securities:							
Contingently convertible debt (5.0% Convertible Notes)	8,563	4,638		43		4,681	
Stock compensation plans	435						
Diluted earnings (loss) and shares	62,300	\$ 65,242	\$ 1.05	\$ (2,776)	\$ (0.05)	\$ 62,466	\$ 1.00

	Weighted Average Shares	Nine Months Ended September 30, 2011					
		Income (Loss) From Continuing Operations		Income (Loss) From Discontinued Operations		Net Income (Loss)	
		Amount	Per Share	Amount	Per Share	Amount	Per Share
			Amount		Amount		Amount
Earnings (loss) and shares	52,414	\$ 59,083		\$ (3,367)		\$ 55,716	
Effect of participating securities:							
Non-vested restricted stock and stock units		(773)				(773)	
Basic earnings (loss) and shares	52,414	\$ 58,310	\$ 1.11	\$ (3,367)	\$ (0.06)	\$ 54,943	\$ 1.05
Effect of dilutive securities:							
Contingently convertible debt (5.0% Convertible Notes)	12,789	6,851		119		6,970	
Stock compensation plans	597						
Diluted earnings (loss) and shares	65,800	\$ 65,161	\$ 0.99	\$ (3,248)	\$ (0.05)	\$ 61,913	\$ 0.94

In addition to the stock options included in the table above, options to purchase approximately 1.3 million shares and 2.1 million shares of Class A common stock were outstanding at September 30, 2012 and September 30, 2011, respectively, but were not included in the computation of diluted earnings per share because the options were not dilutive.

8. Contingencies***Legal and Other Proceedings***

Several private civil actions have been filed against Sonic Automotive, Inc. and several of its dealership subsidiaries that purport to represent classes of customers as potential plaintiffs and make allegations that certain products sold in the finance and insurance departments were done so in a deceptive or otherwise illegal manner. One of these private civil actions was filed on November 15, 2004 in South Carolina state court, York

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County Court of Common Pleas, against Sonic Automotive, Inc. and some of Sonic's South Carolina subsidiaries. The plaintiffs in that lawsuit were Misty J. Owens, James B. Wright, Vincent J. Astey and Joseph Lee Williams, on behalf of themselves and all other persons similarly situated, with plaintiffs seeking monetary damages and injunctive relief on behalf of the purported class. The group of plaintiffs' attorneys representing the plaintiffs in the South Carolina lawsuit also filed another private civil class action lawsuit against Sonic Automotive, Inc. and certain of its subsidiaries on February 14, 2005 in state court in North Carolina, Lincoln County Superior Court, which similarly sought certification of a multi-state class of plaintiffs and alleged that certain products sold in the finance and insurance departments were done so in a deceptive or otherwise illegal manner. The plaintiffs in this North Carolina lawsuit were Robert Price, Carolyn Price, Marcus Cappelletti and Kelly Cappelletti, on behalf of themselves and all

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SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

other persons similarly situated, with plaintiffs seeking monetary damages and injunctive relief on behalf of the purported class. The South Carolina state court action and the North Carolina state court action were subsequently consolidated into a single proceeding in private arbitration before the American Arbitration Association (the Arbitrator). On November 12, 2008, claimants in the consolidated arbitration filed a Motion for Class Certification as a national class action including all of the states in which Sonic operates dealerships except Florida. Claimants are seeking monetary damages and injunctive relief on behalf of this class of customers. The parties have briefed and argued the issue of class certification.

On July 19, 2010, the Arbitrator issued a Partial Final Award on Class Certification, certifying a class which includes all customers who, on or after November 15, 2000, purchased or leased from a Sonic dealership a vehicle with the Etch product as part of the transaction, but not including customers who purchased or leased such vehicles from a Sonic dealership in Florida. The Partial Final Award on Class Certification is not a final decision on the merits of the action. The merits of Claimants' assertions and potential damages would still have to be proven through the remainder of the arbitration. The Arbitrator stayed the Arbitration for thirty days to allow either party to petition a court of competent jurisdiction to confirm or vacate the award. On July 22, 2010, the plaintiffs in this consolidated arbitration filed a Motion to Confirm the Arbitrator's Partial Final Award on Class Certification in state court in North Carolina, Lincoln County Superior Court. On August 17, 2010, Sonic removed this North Carolina state court action to federal court, and simultaneously filed a Petition to Vacate the Arbitrator's Partial Final Award on Class Certification, with both filings made in the United States District Court for the Western District of North Carolina.

On August 12, 2011, the United States District Court for the Western District of North Carolina issued an Order granting Sonic's Petition to Vacate Arbitration Award on Class Certification and denied Claimant's Motion to Dismiss the same. Claimants filed a Notice of Appeal to the United States Fourth Circuit Court of Appeals on September 12, 2011. The federal court's stay of the arbitration proceeding remains in force. At a mediation held January 16, 2012, Sonic reached an agreement with the Claimants to settle this ongoing dispute in its entirety. Sonic and the Claimants subsequently entered into a definitive settlement agreement, the terms of which received preliminary approval by a North Carolina state court in May 2012. The North Carolina state court granted its Final Approval on August 23, 2012 and the settlement became effective on October 2, 2012. The settlement will not have a material adverse effect on Sonic's future results of operations, financial condition and cash flows.

Sonic is involved, and expects to continue to be involved, in numerous legal and administrative proceedings arising out of the conduct of its business, including regulatory investigations and private civil actions brought by plaintiffs purporting to represent a potential class or for which a class has been certified. Although Sonic vigorously defends itself in all legal and administrative proceedings, the outcomes of pending and future proceedings arising out of the conduct of Sonic's business, including litigation with customers, employment related lawsuits, contractual disputes, class actions, purported class actions and actions brought by governmental authorities, cannot be predicted with certainty. An unfavorable resolution of one or more of these matters could have a material adverse effect on Sonic's business, financial condition, results of operations, cash flows or prospects. Included in other accrued liabilities at both September 30, 2012 and December 31, 2011 was approximately \$7.3 million in reserves that Sonic has provided for pending proceedings. Except as reflected in such reserves, Sonic is currently unable to estimate a range of reasonably possible loss, or a range of reasonably possible loss in excess of the amount accrued, for pending proceedings.

Guarantees and Indemnification Obligations

In accordance with the terms of Sonic's operating lease agreements, Sonic's dealership subsidiaries, acting as lessees, generally agree to indemnify the lessor from certain exposure arising as a result of the use of the leased premises, including environmental exposure and repairs to leased property upon termination of the lease. In addition, Sonic has generally agreed to indemnify the lessor in the event of a breach of the lease by the lessee.

In connection with dealership dispositions, certain of Sonic's dealership subsidiaries have assigned or sublet to the buyer its interests in real property leases associated with such dealerships. In general, the subsidiaries retain responsibility for the performance of certain obligations under such leases, including rent payments, and repairs to leased property upon termination of the lease, to the extent that the assignee or sub-lessee does not perform. In the event the sub-lessees do not perform under their obligations Sonic remains liable for the lease payments. The total amount relating to this risk was approximately \$106.0 million as of December 31, 2011.

In accordance with the terms of agreements entered into for the sale of Sonic's franchises, Sonic generally agrees to indemnify the buyer from certain exposure and costs arising subsequent to the date of sale, including environmental exposure and exposure resulting from the breach of

representations or warranties made in accordance with the agreement. While

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SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES

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Sonic's exposure with respect to environmental remediation and repairs is difficult to quantify, Sonic's maximum exposure associated with these general indemnifications was approximately \$15.9 million and \$3.1 million at September 30, 2012 and December 31, 2011, respectively. These indemnifications expire within a period of 12 to 24 months following the date of sale. The estimated fair value of these indemnifications was not material and the amount recorded for this contingency was not significant at September 30, 2012. Sonic also guarantees the floor plan commitments of its 50% owned joint venture, the amount of which was \$4.5 million at both September 30, 2012 and December 31, 2011.

9. Fair Value Measurements

In determining fair value, Sonic uses various valuation approaches including market, income and/or cost approaches. Fair Value Measurements and Disclosures in the Accounting Standards Codification (the ASC) establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of Sonic. Unobservable inputs are inputs that reflect Sonic's assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the reliability of inputs as follows:

Level 1 Valuations based on quoted prices in active markets for identical assets or liabilities that Sonic has the ability to access. Assets utilizing Level 1 inputs include marketable securities that are actively traded.

Level 2 Valuations based on quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly. Assets and liabilities utilizing Level 2 inputs include cash flow swap instruments.

Level 3 Valuations based on inputs that are unobservable and significant to the overall fair value measurement. Asset and liability measurements utilizing Level 3 inputs include those used in estimating fair value of non-financial assets and non-financial liabilities in purchase acquisitions, those used in assessing impairment of property, plant and equipment and other intangibles and those used in the reporting unit valuation in the annual goodwill impairment evaluation.

The availability of observable inputs can vary and is affected by a wide variety of factors. To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires more judgment. Accordingly, the degree of judgment required by Sonic in determining fair value is greatest for assets and liabilities categorized in Level 3. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, for disclosure purposes, the level in the fair value hierarchy within which the fair value measurement is disclosed is determined based on the lowest level input (Level 3 being the lowest level) that is significant to the fair value measurement.

Fair value is a market-based measure considered from the perspective of a market participant who holds the asset or owes the liability rather than an entity-specific measure. Therefore, even when market assumptions are not readily available, Sonic's own assumptions are set to reflect those that market participants would use in pricing the asset or liability at the measurement date. Sonic uses inputs that are current as of the measurement date, including during periods when the market may be abnormally high or abnormally low. Accordingly, fair value measurements can be volatile based on various factors that may or may not be within Sonic's control.

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Assets or liabilities recorded at fair value in the accompanying Unaudited Condensed Consolidated Balance Sheets as of September 30, 2012 are as follows:

(In millions)	Total	Fair Value at September 30, 2012		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash flow swaps designated as hedges (1)	\$ 34.3	\$	\$ 34.3	\$
Cash flow swaps not designated as hedges (2)	3.0		3.0	
Deferred compensation plan (3)	14.0		14.0	
Total	\$ 51.3	\$	\$ 51.3	\$

(1) Approximately \$11.6 million and \$22.7 million were included in other accrued liabilities and other long-term liabilities, respectively, in the accompanying Unaudited Condensed Consolidated Balance Sheets.

(2) Approximately \$0.7 million and \$2.3 million are included in other accrued liabilities and other long-term liabilities, respectively, in the accompanying Unaudited Condensed Consolidated Balance Sheets.

(3) Included in other long-term liabilities in the accompanying Unaudited Condensed Consolidated Balance Sheets.

Assets or liabilities measured at fair value on a non-recurring basis in the accompanying Unaudited Condensed Consolidated Balance Sheets as of September 30, 2012 are as follows:

(In millions)	Balance as of September 30, 2012	Significant Unobservable Inputs (Level 3) as of September 30, 2012	Total Gains / (Losses) for the Nine Months Ended September 30, 2012
Long-lived assets held and used	\$ 567.9	\$ 567.9	\$
Goodwill			