LITHIA MOTORS INC
Form 10-Q
October 26, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2012
OR
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission file number: 001-14733

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

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

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

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

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

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

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

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

Class A common stock without par value	22,789,198
Class B common stock without par value	2,762,261
(Class)	(Outstanding at October 26, 2012)

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PART I - FINANCIAL INFORMATION
Item 1. Financial Statements
LITHIA MOTORS, INC. AND SUBSIDIARIES
Consolidated Balance Sheets
(In thousands)
(Unaudited)

	September 30, 2012	December 31, 2011
Assets		
Current Assets:		
Cash and cash equivalents	$19,757	$20,851
Accounts receivable, net of allowance for doubtful accounts of $319 and $261	128,602	99,407
Inventories, net	658,694	506,484
Deferred income taxes	4,532	4,730
Other current assets	11,240	16,719
Assets held for sale	14,671	-
Total Current Assets	837,496	648,191
Property and equipment, net of accumulated depreciation of $95,853 and $99,115	397,754	373,779
Goodwill	25,838	18,958
Franchise value	61,972	59,095
Deferred income taxes	23,005	29,270
Other non-current assets	20,472	16,840
Total Assets	$1,366,537	$1,146,133
Liabilities and Stockholders' Equity		
Current Liabilities:		
Floor plan notes payable	$14,073	$114,760
Floor plan notes payable: non-trade	489,935	229,180
Current maturities of long-term debt	7,810	8,221
Trade payables	38,973	31,712
Accrued liabilities	81,635	72,711
Liabilities related to assets held for sale	10,065	-
Total Current Liabilities	642,491	456,584
Long-term debt, less current maturities	261,419	278,653
Deferred revenue	31,857	25,146
Other long-term liabilities	21,286	18,629
Total Liabilities	957,053	779,012
Stockholders' Equity:		
Preferred stock - no par value; authorized 15,000 shares; none outstanding	-	-
Class A common stock - no par value; authorized 100,000 shares; issued and outstanding 22,606 and 22,195	266,104	279,366
Class B common stock - no par value; authorized 25,000 shares; issued and outstanding 2,912 and 3,762	362	468
Additional paid-in capital	11,789	10,918

Accumulated other comprehensive loss	(3,234)	(4,508)
Retained earnings	134,463	80,877
Total Stockholders' Equity	409,484	367,121
Total Liabilities and Stockholders' Equity	$1,366,537	$1,146,133

See accompanying condensed notes to consolidated financial statements.

LITHIA MOTORS, INC. AND SUBSIDIARIES
Consolidated Statement of Operations
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenues:				
New vehicle	$496,365	$377,860	$1,355,463	$1,015,872
Used vehicle retail	230,278	184,632	632,361	512,006
Used vehicle wholesale	35,419	35,597	104,663	93,800
Finance and insurance	31,088	22,423	83,440	61,915
Service, body and parts	90,626	84,592	262,589	236,216
Fleet and other	4,597	10,111	28,971	30,408
Total revenues	888,373	715,215	2,467,487	1,950,217
Cost of sales:				
New vehicle	460,754	348,495	1,255,024	936,762
Used vehicle retail	196,735	157,902	539,121	436,196
Used vehicle wholesale	35,446	35,663	103,998	93,204
Service, body and parts	46,866	43,478	135,545	121,173
Fleet and other	4,348	9,442	27,933	27,927
Total cost of sales	744,149	594,980	2,061,621	1,615,262
Gross profit	144,224	120,235	405,866	334,955
Asset impairments	-	-	115	872
Selling, general and administrative	96,380	84,360	280,292	240,537
Depreciation and amortization	4,381	4,129	12,777	12,372
Operating income	43,463	31,746	112,682	81,174
Floor plan interest expense	(3,397)	(1,977)	(9,402)	(7,723)
Other interest expense	(2,131)	(3,067)	(7,398)	(9,353)
Other income, net	452	213	1,771	462
Income from continuing operations before income taxes	38,387	26,915	97,653	64,560
Income tax provision	(15,048)	(10,594)	(37,287)	(25,244)
Income from continuing operations, net of income tax	23,339	16,321	60,366	39,316
Income (loss) from discontinued operations, net of income tax	(96)	242	164	778
Net income	$23,243	$16,563	$60,530	$40,094
Basic income per share from continuing operations	$0.92	$0.62	$2.35	$1.49
Basic income (loss) per share from discontinued operations	(0.01)	0.01	-	0.03
Basic net income per share	$0.91	$0.63	$2.35	$1.52
Shares used in basic per share calculations	25,469	26,189	25,730	26,324
Diluted income per share from continuing operations	$0.90	$0.61	$2.30	$1.47
Diluted income (loss) per share from discontinued operations	-	0.01	0.01	0.03
Diluted net income per share	$0.90	$0.62	$2.31	$1.50

Shares used in diluted per share calculations	25,947	26,654	26,203	26,738

See accompanying condensed notes to consolidated financial statements.

LITHIA MOTORS, INC. AND SUBSIDIARIES
Consolidated Statement of Comprehensive Income
(In thousands)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income	$23,243	$16,563	$60,530	$40,094
Other comprehensive income (loss), net of tax:				
Gain (loss) on cash flow hedges, net of tax expense (benefit) of $301, ($386), $791 and ($101), respectively	484	(623)	1,274	(117)
Comprehensive income	$23,727	$15,940	$61,804	$39,977

See accompanying condensed notes to consolidated financial statements.

LITHIA MOTORS, INC. AND SUBSIDIARIES
Consolidated Statement of Cash Flows
(In thousands)
(Unaudited)

	Nine Months Ended September 30,	
	2012	2011
Cash flows from operating activities:		
Net income	$60,530	$40,094
Adjustments to reconcile net income to net cash used in operating activities:		
Asset impairments	115	872
Depreciation and amortization	12,777	12,372
Depreciation and amortization within discontinued operations	96	381
Stock-based compensation	2,329	1,686
Gain on disposal of other assets	(775)	(134)
(Gain) loss from disposal activities within discontinued operations	397	(116)
Deferred income taxes	6,851	3,325
Excess tax benefit from share-based payment arrangements	(1,629)	(360)
(Increase) decrease (net of acquisitions and dispositions):		
Trade receivables, net	(29,160)	(7,177)
Inventories	(158,186)	(53,389)
Other current assets	3,169	(1,078)
Other non-current assets	(4,346)	(4,079)
Increase (decrease) (net of acquisitions and dispositions):		
Floor plan notes payable	(93,975)	(10,637)
Trade payables	5,381	3,759
Accrued liabilities	10,164	9,890
Other long-term liabilities and deferred revenue	9,927	8,018
Net cash provided by (used in) operating activities	(176,335)	3,427
Cash flows from investing activities:		
Principal payments received on notes receivable	79	97
Capital expenditures	(34,966)	(22,996)
Proceeds from sales of assets	6,025	11,217
Cash paid for acquisitions, net of cash acquired	(31,376)	(58,420)
Payments for life insurance policies	(1,908)	(900)
Proceeds from sales of stores	2,901	6,517
Net cash used in investing activities	(59,245)	(64,485)
Cash flows from financing activities:		
Borrowings on floor plan notes payable: non-trade	272,760	67,402
Borrowings on lines of credit	365,623	38,000
Repayments on lines of credit	(356,791)	(9,000)
Principal payments on long-term debt, scheduled	(5,889)	(6,175)
Principal payments on long-term debt and capital leases, other	(37,366)	(28,679)
Proceeds from issuance of long-term debt	14,169	22,674
Proceeds from issuance of common stock	4,600	2,848
Repurchase of common stock	(20,606)	(11,436)

Excess tax benefit from share-based payment arrangements	1,629	360
Decrease (Increase) in restricted cash	3,300	(3,300)
Dividends paid	(6,943)	(5,006)
Net cash provided by financing activities	234,486	67,688
Increase (decrease) in cash and cash equivalents	(1,094)	6,630
Cash and cash equivalents at beginning of period	20,851	9,306
Cash and cash equivalents at end of period	$19,757	$15,936
Supplemental disclosure of cash flow information:		
Cash paid during the period for interest	$17,316	$18,485
Cash paid during the period for income taxes, net	25,814	20,210
Supplemental schedule of non-cash activities:		
Floor plan debt acquired in connection with acquisitions	-	18,553
Acquisition of assets with capital leases	2,609	-
Floor plan debt paid in connection with store disposals	6,712	-

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, 2012 and for the three- and nine-month periods ended September 30, 2012 and 2011. 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 2011 audited Consolidated Financial Statements and the related notes thereto. The financial information as of December 31, 2011 is derived from our 2011 Annual Report on Form 10-K. The interim condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and the notes thereto included in our 2011 Annual Report on Form 10-K. The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for the full year.

Reclassifications
Certain reclassifications of amounts previously reported have been made to the accompanying consolidated financial statements to maintain consistency and comparability between periods presented. The results of operations of stores classified as discontinued operations have been presented on a comparable basis for all periods presented in the accompanying consolidated statements of operations. See also Note 14.

These reclassifications had no impact on previously reported net income.

Note 2. Inventories
The components of inventory consisted of the following (in thousands):

	September 30, 2012	December 31, 2011
New vehicles	$ 503,915	$ 372,838
Used vehicles	125,623	106,622
Parts and accessories	29,156	27,024
Total inventories	$ 658,694	$ 506,484

Note 3. Goodwill
The changes in the carrying amounts of goodwill are as follows (in thousands):

	Goodwill
Balance as of December, 31, 2010, gross	$ 305,452
Accumulated impairment loss	(299,266)
Balance as of December 31, 2010, net	6,186
Additions through acquisitions	12,869
Goodwill allocated to dispositions	(97)
Balance as of December 31, 2011, net	18,958
Additions through acquisitions	7,161
Goodwill allocated to dispositions	(281)

Balance as of September 30, 2012, net	$	25,838

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Note 4. Credit Facility

We have a $650 million credit facility with a syndicate of 10 financial institutions, including four manufacturer-affiliated finance companies. This credit facility provides a $500 million new vehicle floor plan commitment, $100 million in used vehicle inventory financing and a $50 million revolving line of credit for general corporate use including working capital and acquisitions. We have the ability to expand the credit facility to $800 million total availability upon credit approval. The credit facility expires on April 16, 2017. All borrowings from, and repayments to, our syndicated lending group are presented in the Consolidated Statements of Cash Flows as financing activities. The interest rate on the credit facility varies based on the type of debt with the rate ranging from the 1-month LIBOR plus 1.50% to the 1-month LIBOR plus 2.50%. Our financial covenants related to this credit facility include maintaining a current ratio of not less than 1.20x, a fixed charge coverage ratio of not less than 1.20x, a leverage ratio of not more than 5.0x and a funded debt restriction that limits the amount of other debt we may have outstanding to $375 million.

As of September 30, 2012, $489.9 million was outstanding on our new vehicle floor plan commitment, $77.9 million was outstanding on our used vehicle inventory financing facility and $17.9 million was outstanding on our revolving line of credit. An additional $10.1 million of outstanding floor plan notes payable was classified as liabilities related to assets held for sale. See also Note 14.

Note 5. Commitments and Contingencies

Litigation

We are party to numerous legal proceedings arising in the normal course of our business. Although we do not anticipate that the resolution of legal proceedings arising in the normal course of business or the proceedings described below will have a material adverse effect on our business, results of operations, financial condition, or cash flows, we cannot predict this with certainty.

Text Messaging Claims

In April 2011, a third party vendor assisted us in promoting a targeted “0% financing on used vehicles” advertising campaign during a limited sale period. The marketing included sending a “Short Message Service” communication to cell phones (a “text message”) of our previous customers. The message was sent to over 50,000 cell phones in 14 states. The message indicated that the recipients could “Opt-Out” of receiving any further messages by replying “STOP,” but, due to a technical error, some recipients who responded requesting to be unsubscribed nonetheless may have received a follow-on message.

On April 21, 2011, a Complaint for Damages, Injunctive and Declaratory Relief was filed against us (Kevin McClintic vs. Lithia Motors, 11-2-14632-4 SEA, Superior Court of the State of Washington for King County) alleging the text messaging activity violated State of Washington anti-texting and consumer protection laws and the federal Telephone Consumer Protection Act, and seeking statutory damages of $500 for each violation, trebled, plus injunctive relief and attorney fees. The suit seeks class action designation for all similarly situated entities and individuals. The suit was removed to the United States District Court for the Western District of Washington at Seattle.

On July 5, 2011, we participated in a mediation of the McClintic case and subsequently entered into a settlement agreement with the plaintiffs, which was subject to final court approval. Under this settlement agreement, we agreed to pay a total of $2.5 million, all of which such amounts will be reimbursed by the vendor pursuant to contractual indemnification. These amounts were recorded as a component of other current assets and accrued liabilities on our Consolidated Balance Sheet as of September 30, 2012. On October 11, 2012, the court approved the settlement.

On July 5, 2011, a complaint was filed alleging nearly identical claims, also seeking class action designation (Dan McLaren vs. Lithia Motors, Civil # 11-810, United States District Court of Oregon, Portland Division). Subsequently,

the complaint was amended to include claims against the vendor. The class representative in the McLaren case attempted to intervene in the McClintic case. This intervention motion was denied on October 19, 2011. The McLaren case was dismissed by the court with prejudice as to Lithia Motors on September 5, 2012.

Alaska Consumer Protection Act Claims
In December 2006, a suit was filed against us (Jackie Neese, et al vs. Lithia Chrysler Jeep of Anchorage, Inc, et al, Case No. 3AN-06-13341 CI, and in April, 2007, a second case (Jackie Neese, et al vs. Lithia Chrysler Jeep of Anchorage, Inc, et al, Case No. 3AN-06-4815 CI) (now consolidated)), in the Superior Court for the State of Alaska, Third Judicial District at Anchorage. In the suits, plaintiffs alleged that we, through our Alaska dealerships, engaged in three practices that purportedly violate Alaska consumer protection laws: (i) charging customers dealer fees and costs (including document preparation fees) not disclosed in the advertised price, (ii) failing to disclose the acquisition, mechanical and accident history of used vehicles or whether the vehicles were originally manufactured for sale in a foreign country, and (iii) engaging in deception, misrepresentation and fraud by providing to customers financing from third parties without disclosing that we receive a fee or discount for placing that loan (a "dealer reserve"). The suit seeks statutory damages of $500 for each violation (or three times plaintiff's actual damages, whichever is greater), and attorney fees and costs and the plaintiffs sought class action certification. Before and during the pendency of these suits, we engaged in settlement discussions with the State of Alaska through its Office of Attorney General with respect to the first two practices enumerated above. As a result of those discussions, we entered into a Consent Judgment subject to court approval and permitted potential class members to "opt-out" of the proposed settlement. Counsel for the plaintiffs attempted to intervene and, after various motions, hearings and an appeal to the state Court of Appeals, the Consent Judgment became final.

Plaintiffs then filed a motion in November 2010 seeking certification of a class (i) for the 339 customers who "opted-out" of the state settlement, (ii) for those customers who did not qualify for recovery under the Consent Judgment but were allegedly eligible for recovery under the plaintiffs' broader interpretation of the applicable statutes, and (iii) arguing that since the State's suit against our dealerships did not address the loan fee/discount (dealer reserve) claim, for those customers who arranged their vehicle financing through us. On June 14, 2011, the Trial Court granted plaintiffs' motion to certify a class without addressing either the merits of the claims or the size of the classes. Discovery in this case is ongoing. We intend to defend the claims vigorously and do not believe the novel "dealer reserve" claim has merit.

Note 6. Stockholders' Equity

Share Repurchases
In August 2011, our Board of Directors authorized the repurchase of up to 2,000,000 shares of our Class A common stock. On July 20, 2012, our Board of Directors authorized the repurchase of 1,000,000 additional shares of our Class A common stock. We did not repurchase any shares of our Class A common stock during the third quarter of 2012. Through September 30, 2012, we have repurchased 1,120,147 shares, of which 823,092 were purchased in 2012 at an average price of $24.17 per share. At September 30, 2012, 1,879,853 shares remained available for repurchase. This plan does not have an expiration date and we may continue to repurchase shares from time to time as conditions warrant.

Dividends

Dividends declared and paid on our Class A and Class B common stock during the first three quarters of 2012 were as follows:

Quarter declared:	Dividend amount per share	Total amount of dividend (in thousands)
First quarter	$ 0.07	$ 1,815
Second quarter	0.10	2,583
Third quarter	0.10	2,545

See Note 17 for a discussion of a dividend related to our third quarter 2012 financial results.

Note 7. Asset Impairment Charges

Long-lived assets classified as held and used are reviewed for impairment whenever events or circumstances indicate that the carrying amount of such 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 asset is determined to not be recoverable and the carrying value of the asset exceeds its fair value.

Triggering events were determined to have occurred related to certain properties due to changes in the expected future use. We evaluated the future undiscounted net cash flows for each property and determined the carrying value was not recoverable. We concluded the carrying value of the assets exceeded the fair value. As a result, asset impairments were recorded as a component of continuing operations as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Long-lived assets	$ -	$ -	$ 115	$ 872

Note 8. Stock-Based Compensation

In the first quarter of 2012, we granted 168,000 restricted stock units (“RSUs”), subject to performance measures discussed below, to certain employees. Each grant entitles the holder to receive shares of our Class A common stock upon vesting. A quarter of the RSUs vest on each of the second and third anniversaries of the grant date and the remaining RSUs vest on the fourth anniversary of the grant date.

Our executives and other key employees received 89,000 of the 168,000 RSUs granted based on attaining a target level of earnings per share for 2012. The RSUs are subject to forfeiture, in whole or in part, based upon minimum performance measures and continuation of employment. If minimum performance measures are met, the number of RSUs received under these grants is subject to attainment of specific earnings per share thresholds. Each earnings per share threshold specifies an attainment level ranging from 75% to 150% of the base number of units identified in the grant. At the 150% maximum attainment level, the number of RSUs would increase by 44,500 for a total award of 133,500 RSUs. Failure to achieve the minimum performance threshold in 2012 will result in forfeiture of the entire grant. The final attainment will be calculated using the 2012 adjusted net income per share from continuing operations with the attainment percentage determined on a pro-rata basis ranging between 75% and 150%.

We estimated compensation expense, based on a fair value methodology, of $4.2 million related to the RSUs, which is being recognized over the vesting period. Of this amount, approximately $0.9 million is expected to be recognized in 2012.

In the second quarter of 2012, we granted RSUs covering 12,870 shares of our Class A common stock to members of our Board of Directors. These awards vest 25% on the first day of each month following our quarterly board meetings. We estimated compensation expense, based on a fair value methodology, of $0.4 million related to these RSUs, which is being recognized over the vesting period. Of this amount, approximately $0.3 million is expected to be recognized in 2012.

Note 9. Deferred Compensation and Long-term Incentive Plan

We offer a deferred compensation and long-term incentive plan (the "Plan") to provide certain employees the ability to accumulate assets for retirement on a tax deferred basis. We may make discretionary contributions to the Plan. Discretionary contributions vest between one and seven years based on the employee's age and position. Additionally, participants may defer a portion of their compensation and are fully vested in their respective deferrals.

In March 2012, we made a discretionary contribution of $1.9 million to the Plan. Participants will receive a guaranteed return of 5.9% in 2012. We recognized compensation expense related to the Plan of $0.3 million and $0.9 million, respectively, for the three and nine months ended September 30, 2012 and $0.3 million and $0.6 million, respectively, for the three and nine months ended September 30, 2011.

Note 10. 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 and 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 swaps 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 valuations 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. The same methodology is used to determine the rate used to discount the future cash flows. The valuation of the interest rate swaps also takes into consideration our own, as well as the counterparty's, risk of non-performance under the contract. See Note 11 for more details regarding our derivative contracts.

We estimate the fair value of our assets held for sale based on a market valuation approach, which uses prices and other relevant information generated primarily by recent market transactions involving similar or comparable assets or liabilities, as well as our historical experience in divestitures, acquisitions and real estate transactions. When available, we use inputs from independent valuation experts, such as brokers and real estate appraisers, to corroborate our internal estimates. Because these valuations contain unobservable inputs, we classified the assets held for sale and liabilities related to assets held for sale 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. As 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, 2012.

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, 2012	Level 1	Level 2	Level 3
Measured on a recurring basis:			
Derivative contracts, net	$ -	$ (5,643)	$ -
Measured on a non-recurring basis:			
Assets held for sale	$ -	$ -	$ 14,671

Fair Value at December 31, 2011	Level 1	Level 2	Level 3
Measured on a recurring basis:			
Derivative contracts, net	$ -	$ (7,530)	$ -
Measured on a non-recurring basis:			
Long-lived assets held and used:			
Certain buildings and improvements	$ -	$ -	$ 2,500

During the three and nine months ended September 30, 2012, we recognized an unrealized loss of $0.4 million as a component of discontinued operations associated with our asset group classified as held for sale. We had no amounts recorded as assets held for sale as of December 31, 2011. See also Note 14.

Fair Value Disclosures for Financial Assets and Liabilities

We determined the carrying value of cash equivalents, accounts receivables, trade payables, accrued liabilities and short-term borrowings approximate their fair values because of the short term nature 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, 2012, this debt had maturity dates between November 2016 and May 2031. 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, 2012	December 31, 2011
Carrying value	$ 103,684	$ 64,463

Fair value	108,702	73,551

Note 11. Derivative Instruments

We enter into interest rate swaps to manage the variability of our interest rate exposure, thus fixing a portion of our interest expense in a rising or falling rate environment. 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.

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 income (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.

At September 30, 2012 and December 31, 2011, the net fair value of all of our agreements totaled a loss of $5.6 million and $7.5 million, respectively, which was recorded on our Consolidated Balance Sheets as a component of accrued liabilities and other long-term liabilities. The estimated amount expected to be reclassified into earnings within the next twelve months was $2.7 million at September 30, 2012.

As of September 30, 2012, we had outstanding the following interest rate swaps with U.S. Bank Dealer Commercial Services:

- $25 million interest rate swap at a fixed rate of 4.495% per annum, variable rate adjusted on the 26th of each month, matures January 25, 2013;
- $25 million interest rate swap at a fixed rate of 3.495% per annum, variable rate adjusted on the 1st and 16th of each month, matures April 30, 2013;
- $25 million interest rate swap at a fixed rate of 3.495% per annum, variable rate adjusted on the 1st and 16th of each month, matures April 30, 2013 and
- $25 million interest rate swap at a fixed rate of 5.587% per annum, variable rate adjusted on the 1st and 16th of each month, matures June 15, 2016.

We receive interest on all of the interest rate swaps at the one-month LIBOR rate. The one-month LIBOR rate at September 30, 2012 was 0.23% per annum, as reported in the Wall Street Journal.

At September 30, 2012 and December 31, 2011, 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	
	Location in Balance Sheet	September 30, 2012
Derivatives Designated as Hedging Instruments		
Interest Rate Swap Contracts	Accrued liabilities	$ 2,520
	Other long-term liabilities	3,123
		$ 5,643

Balance Sheet Information	Fair Value of Liability Derivatives	
	Location in Balance Sheet	December 31, 2011
Derivatives Designated as Hedging Instruments		
Interest Rate Swap Contracts	Accrued liabilities	$ 3,522
	Other long-term liabilities	4,008
		$ 7,530

The effect of derivative instruments on our Consolidated Statements of Operations for the three- and nine-month periods ended September 30, 2012 and 2011 was as follows (in thousands):

Derivatives in Cash Flow Hedging Relationships	Amount of Gain (Loss) 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 Gain (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)	Amount of Gain (Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)
Three Months Ended September 30, 2012					
Interest Rate Swap Contracts	$476	Floor plan interest expense	$(309)	Floor plan interest expense	$(788)
Three Months Ended September 30, 2011					
Interest Rate Swap Contracts	$(1,544)	Floor plan interest expense	$(535)	Floor plan interest expense	$271

Derivatives in Cash Flow Hedging Relationships	Amount of Gain (Loss) 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, 2012					
Interest Rate Swap Contracts	$998	Floor plan interest expense	$(1,067)	Floor plan interest expense	$(2,172)
Nine Months Ended September 30, 2011					
Interest Rate Swap Contracts	$(1,664)	Floor plan interest expense	$(1,446)	Floor plan interest expense	$(1,002)

See also Note 10.

Note 12. Related Party Transactions

On March 27, 2012, we completed the sale of an 80% interest in our Nissan, Volkswagen and BMW stores in Medford, Oregon to Dick Heimann, a director and our Vice Chairman. We received proceeds of $9.6 million, of which $2.9 million was received in cash and $6.7 million was received through the payoff of floor plan financing. The sale of the 80% interest in the stores resulted in a gain of $0.7 million and was recorded as a component of selling, general and administrative expense on our Consolidated Statements of Operations.

The Nissan and Volkswagen stores were purchased for the book value of the inventory as defined by the original terms of an option agreement provided to Mr. Heimann in 2009. The price of the intangible assets of $1.2 million was based on the fair value of the intangible assets related to the BMW store. We corroborated the fair value of the BMW store’s intangible assets with independent third party broker opinions and financial projections using a fair value income approach.

When we sold the three stores, we entered into a shared service agreement with the stores. This agreement allows the stores to lease our employees, use the Lithia name, utilize accounting support functions and receive consulting services. The services provided and the costs of the services are structured the same as the shared services provide to our wholly owned stores.

We retained a 20% interest in the stores as of the transaction date. We determined that we are not the primary beneficiary of the stores and the risk and rewards associated with our investment are based on ownership percentages. As a result, the stores do not qualify for consolidation and our 20% interest is accounted for under the equity method. We determined we maintained significant influence over the operations. We recorded the equity investment at fair value of $0.8 million as of the transaction date that resulted in a gain of $0.2 million. The gain was recorded as a component of other income on our Consolidated Statements of Operations. We determined the fair value of our equity investment based on independent third party broker opinions and financial projections using a fair value income approach.

As of September 30, 2012, our equity investment increased by $0.2 million to $1.0 million and was recorded as a component of other non-current assets in our Consolidated Balance Sheets.

Note 13. Acquisitions

We completed the following acquisitions in the first nine months of 2012:

- On April 30, 2012, we acquired the inventory, equipment and intangible assets and assumed certain liabilities of Bellingham Chevrolet and Cadillac in Bellingham, Washington from Jerry Chambers Chevrolet.
- On June 12, 2012, we acquired the inventory, equipment and intangible assets and assumed certain liabilities of Fairbanks GMC Buick from Gene's GMC, LLC.
- On August 27, 2012, we acquired the inventory, equipment and intangible assets and assumed certain liabilities of Killeen Chevrolet in Killeen, Texas from Connell Chevrolet, Inc.

These acquisitions contributed revenues of $12.5 million for the nine months ended September 30, 2012.

The following unaudited pro forma summary presents consolidated information as if the above acquisitions had occurred on January 1, 2011 (in thousands, except for per share amounts):

Three Months Ended September 30,		2012		2011
Revenue	$	895,813	$	734,638
Income from continuing operations, net of tax		23,492		16,542
Basic income per share from continuing operations, net of tax		0.92		0.63
Diluted income per share from continuing operations, net of tax		0.91		0.62

Nine Months Ended September 30,		2012		2011
Revenue	$	2,512,479	$	2,003,178
Income from continuing operations, net of tax		60,987		39,848
Basic income per share from continuing operations, net of tax		2.37		1.51
Diluted income per share from continuing operations, net of tax		2.33		1.49

These amounts have been calculated by estimating and applying our accounting policies. The results of these stores have been adjusted to reflect depreciation on a straight-line basis over our 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 these business combinations are included in the reported pro forma revenues and earnings.

The above acquisitions were all accounted for under the acquisition method of accounting. No portion of the purchase price was paid with our equity securities. The following table summarizes the consideration paid for 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	$ 31,376

	Assets Acquired and Liabilities Assumed
Inventories	$ 15,648
Franchise value	2,877
Property, plant and equipment	8,484
Other assets	94
Capital lease obligations	(2,609)
Other liabilities	(279)
	24,215
Goodwill	7,161
	$ 31,376

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.

Note 14. Discontinued Operations

We classify a store as discontinued operations if the location has been sold, we have ceased operations at that location or if management has committed to a plan to dispose of the store. Additionally, the store must meet the criteria as required by U.S. generally accepted accounting standards:

- 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.

We reclassify the store’s operations to discontinued operations in our Consolidated Statements of Operations, on a comparable basis for all periods presented, provided we do not expect to have any significant continuing involvement in the store’s operations after its disposal.

In September 2012, we determined that two of our stores met the criteria for classification of the assets and related liabilities as held for sale. Additionally, the historical operating results for the stores were classified as discontinued operations. In 2011, we sold three stores: a Chrysler Jeep Dodge FIAT store in Concord, California; a Volkswagen store in Thornton, Colorado; and a GMC Buick and Kia store in Cedar Rapids, Iowa.

Interest expense is allocated to stores classified as discontinued operations for actual flooring interest expense directly related to the new vehicles in the stores. Interest expense related to our used vehicle inventory financing and revolving line of credit is allocated based on the working capital level of each store.

Certain financial information related to discontinued operations was as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenue	$ 14,562	$ 28,800	$ 41,465	$ 89,423
Pre-tax gain from discontinued operations	$ 256	$ 227	$ 672	$ 1,153
Gain (loss) on disposal activities	(397)	169	(397)	116
	(141)	396	275	1,269
Income tax benefit (expense)	45	(154)	(111)	(491)
Income (loss) from discontinued operations, net of income tax benefit (expense)	$ (96)	$ 242	$ 164	$ 778
Cash generated from disposal activities	$ -	$ 6,105	$ 2,901	$ 6,517
Floor plan debt paid in connection with disposal activities	$ -	$ -	$ 6,712	$ -

The gain (loss) on disposal activities included the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Goodwill	$ (50)	$ -	$ (50)	$ -
Property, plant and equipment	(347)	-	(347)	-
Other	-	169	-	116
	$ (397)	$ 169	$ (397)	$ 116

As of September 30, 2012, we had two stores classified as held for sale. There were no stores classified as held for sale as of December 31, 2011. Assets held for sale included the following (in thousands):

	September 30, 2012
Inventories	$ 11,671
Property, plant and equipment	3,000
	$ 14,671

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

	September 30, 2012
Floor plan notes payable	$ 10,065

Note 15. 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 incremental common shares issuable upon the exercise of stock options and unvested restricted shares subject to repurchase or cancellation. The dilutive effect of

outstanding stock options and other grants 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. Our Articles of Incorporation require that the Class A and Class B common stock must 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, which would have the effect of adversely altering 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 for the three- and nine-month periods ended September 30, 2012 and 2011 (in thousands, except per share amounts):

Three Months Ended September 30,	2012		2011	
Basic EPS from Continuing Operations	Class A	Class B	Class A	Class B
Numerator:				
Income from continuing operations applicable to common stockholders	$20,287	$3,052	$13,976	$2,344
Distributed income applicable to common stockholders	(2,212)	(333)	(1,574)	(264)
Basic undistributed income from continuing operations applicable to common stockholders	$18,075	$2,719	$12,402	$2,080
Denominator:				
Weighted average number of shares outstanding used to calculate basic income per share	22,139	3,330	22,427	3,762
Basic income per share from continuing operations applicable to common stockholders	$0.92	$0.92	$0.62	$0.62
Basic distributed income per share from continuing operations applicable to common stockholders	(0.10)	(0.10)	(0.07)	(0.07)
Basic undistributed income per share from continuing operations applicable to common stockholders	$0.82	$0.82	$0.55	$0.55

Three Months Ended September 30,	2012		2011	
Diluted EPS from Continuing Operations	Class A	Class B	Class A	Class B
Numerator:				
Distributed income applicable to common stockholders	$ 2,212	$ 333	$ 1,574	$ 264
Reallocation of distributed income as a result of conversion of dilutive stock options	6	(6)	(5)	5
Reallocation of distributed income due to conversion of Class B to Class A common shares outstanding	327	-	269	-
Diluted distributed income applicable to common stockholders	$ 2,545	$ 327	$ 1,838	$ 269
Undistributed income from continuing operations applicable to common stockholders	$ 18,075	$ 2,719	$ 12,402	$ 2,080
Reallocation of undistributed income as a result of conversion of dilutive stock options	50	(50)	36	(36)
Reallocation of undistributed income due to conversion of Class B to Class A	2,669	-	2,044	-
Diluted undistributed income from continuing operations applicable to common stockholders	$ 20,794	$ 2,669	$ 14,482	$ 2,044
Denominator:				
Weighted average number of shares outstanding used to calculate basic income per share from continuing operations	22,139	3,330	22,427	3,762
Weighted average number of shares from stock options	478	-	465	-
Conversion of Class B to Class A common shares outstanding	3,330	-	3,762	-
Weighted average number of shares outstanding used to calculate diluted income per share from continuing operations	25,947	3,330	26,654	3,762
Diluted income per share from continuing operations applicable to common stockholders	$ 0.90	$ 0.90	$ 0.61	$ 0.61
Diluted distributed income per share from continuing operations applicable to common stockholders	(0.10)	(0.10)	(0.07)	(0.07)
Diluted undistributed income per share from continuing operations applicable to common stockholders	$ 0.80	$ 0.80	$ 0.54	$ 0.54

Three Months Ended September 30,	2012		2011	
Diluted EPS	Class A	Class B	Class A	Class B
Antidilutive Securities				
Shares issuable pursuant to stock options not included since they were antidilutive	-	-	93	-

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Nine Months Ended September 30,	2012		2011	
Basic EPS from Continuing Operations	Class A	Class B	Class A	Class B
Numerator:				
Income from continuing operations applicable to common stockholders	$ 52,072	$ 8,294	$ 33,697	$ 5,619
Distributed income applicable to common stockholders	(5,989)	(954)	(4,291)	(715)
Basic undistributed income from continuing operations applicable to common stockholders	$ 46,083	$ 7,340	$ 29,406	$ 4,904
Denominator:				
Weighted average number of shares outstanding used to calculate basic income per share	22,195	3,535	22,562	3,762
Basic income per share from continuing operations applicable to common stockholders	$ 2.35	$ 2.35	$ 1.49	$ 1.49
Basic distributed income per share from continuing operations applicable to common stockholders	(0.27)	(0.27)	(0.19)	(0.19)
Basic undistributed income per share from continuing operations applicable to common stockholders	$ 2.08	$ 2.08	$ 1.30	$ 1.30

Nine Months Ended September 30,	2012	2011