

CARMAX INC
Form 10-Q
July 07, 2017

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended May 31, 2017

OR

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

Commission File Number: 1-31420

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

VIRGINIA 54-1821055
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

12800 TUCKAHOE CREEK PARKWAY, RICHMOND, VIRGINIA 23238
(Address of principal executive offices) (Zip Code)

(804) 747-0422
(Registrant's telephone number, including area code)

N/A
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes 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 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, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer x Accelerated filer "
Smaller reporting company "

Non-accelerated filer
(Do not check if a smaller
reporting company)

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Yes No

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

| Class | Outstanding as of June 30, 2017 |
|--------------------------------|---------------------------------|
| Common Stock, par value \$0.50 | 183,247,390 |

CARMAX, INC. AND SUBSIDIARIES

TABLE OF CONTENTS

| | | Page No. |
|----------|-----------------------|---|
| PART I. | FINANCIAL INFORMATION | |
| | Item 1. | Financial Statements: |
| | | Consolidated Statements of Earnings (Unaudited) – Three Months Ended May 31, 2017 and 2016 <u>3</u> |
| | | Consolidated Statements of Comprehensive Income (Unaudited) – Three Months Ended May 31, 2017 and 2016 <u>4</u> |
| | | Consolidated Balance Sheets (Unaudited) – May 31, 2017 and February 28, 2017 <u>5</u> |
| | | Consolidated Statements of Cash Flows (Unaudited) – Three Months Ended May 31, 2017 and 2016 <u>6</u> |
| | | Notes to Consolidated Financial Statements (Unaudited) <u>7</u> |
| | Item 2. | Management's Discussion and Analysis of Financial Condition and Results of Operations <u>26</u> |
| | Item 3. | Quantitative and Qualitative Disclosures About Market Risk <u>39</u> |
| | Item 4. | Controls and Procedures <u>39</u> |
| PART II. | OTHER INFORMATION | |
| | Item 1. | Legal Proceedings <u>40</u> |

| | | |
|---------------|---|-----------|
| Item 1A. | Risk Factors | <u>40</u> |
| Item 2. | Unregistered Sales of Equity Securities and Use of Proceeds | <u>40</u> |
| Item 6. | Exhibits | <u>41</u> |
| SIGNATURES | | <u>42</u> |
| EXHIBIT INDEX | | <u>43</u> |

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CARMAX, INC. AND SUBSIDIARIES

Consolidated Statements of Earnings

(Unaudited)

| (In thousands except per share data) | Three Months Ended May 31 | | | |
|--|---------------------------|------------------|------------------|------------------|
| | 2017 | % ⁽¹⁾ | 2016 | % ⁽¹⁾ |
| SALES AND OPERATING REVENUES: | | | | |
| Used vehicle sales | \$3,843,373 | 84.6 | \$3,428,974 | 83.1 |
| Wholesale vehicle sales | 553,390 | 12.2 | 567,741 | 13.8 |
| Other sales and revenues | 145,571 | 3.2 | 129,671 | 3.1 |
| NET SALES AND OPERATING REVENUES | 4,542,334 | 100.0 | 4,126,386 | 100.0 |
| Cost of sales | 3,893,396 | 85.7 | 3,553,749 | 86.1 |
| GROSS PROFIT | 648,938 | 14.3 | 572,637 | 13.9 |
| CARMAX AUTO FINANCE INCOME | 109,363 | 2.4 | 100,758 | 2.4 |
| Selling, general and administrative expenses | 403,503 | 8.9 | 380,230 | 9.2 |
| Interest expense | 16,838 | 0.4 | 11,088 | 0.3 |
| Other income | (93) |)— | (616) |)— |
| Earnings before income taxes | 338,053 | 7.4 | 282,693 | 6.9 |
| Income tax provision | 126,351 | 2.8 | 107,333 | 2.6 |
| NET EARNINGS | \$211,702 | 4.7 | \$175,360 | 4.2 |
| WEIGHTED AVERAGE COMMON SHARES: | | | | |
| Basic | 185,200 | | 193,531 | |
| Diluted | 186,859 | | 195,253 | |
| NET EARNINGS PER SHARE: | | | | |
| Basic | \$1.14 | | \$0.91 | |
| Diluted | \$1.13 | | \$0.90 | |

(1) Percents are calculated as a percentage of net sales and operating revenues and may not total due to rounding.

See accompanying notes to consolidated financial statements.

Page 3

CARMAX, INC. AND SUBSIDIARIES
 Consolidated Statements of Comprehensive Income
 (Unaudited)

| (In thousands) | Three Months Ended | |
|---|--------------------|-----------|
| | May 31 | |
| | 2017 | 2016 |
| NET EARNINGS | \$211,702 | \$175,360 |
| Other comprehensive (loss) income, net of taxes: | | |
| Net change in retirement benefit plan unrecognized actuarial losses | 274 | 249 |
| Net change in cash flow hedge unrecognized losses | (1,948) | 3,122 |
| Other comprehensive (loss) income, net of taxes | (1,674) | 3,371 |
| TOTAL COMPREHENSIVE INCOME | \$210,028 | \$178,731 |

See accompanying notes to consolidated financial statements.

Page 4

CARMAX, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

(Unaudited)

| (In thousands except share data) | As of May 31 2017 | As of February 28 2017 |
|---|----------------------|------------------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$60,080 | \$38,416 |
| Restricted cash from collections on auto loan receivables | 385,692 | 380,353 |
| Accounts receivable, net | 104,745 | 152,388 |
| Inventory | 2,148,247 | 2,260,563 |
| Other current assets | 35,780 | 41,910 |
| TOTAL CURRENT ASSETS | 2,734,544 | 2,873,630 |
| Auto loan receivables, net | 10,892,844 | 10,596,076 |
| Property and equipment, net | 2,557,506 | 2,518,393 |
| Deferred income taxes | 145,265 | 150,962 |
| Other assets | 145,530 | 140,295 |
| TOTAL ASSETS | \$16,475,689 | \$16,279,356 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable | \$510,574 | \$494,989 |
| Accrued expenses and other current liabilities | 203,211 | 266,128 |
| Accrued income taxes | 103,588 | 1,404 |
| Short-term debt | 693 | 62 |
| Current portion of finance and capital lease obligations | 9,772 | 9,491 |
| Current portion of non-recourse notes payable | 338,832 | 333,713 |
| TOTAL CURRENT LIABILITIES | 1,166,670 | 1,105,787 |
| Long-term debt, excluding current portion | 797,666 | 952,562 |
| Finance and capital lease obligations, excluding current portion | 484,394 | 486,645 |
| Non-recourse notes payable, excluding current portion | 10,643,810 | 10,387,231 |
| Other liabilities | 231,021 | 238,551 |
| TOTAL LIABILITIES | 13,323,561 | 13,170,776 |
| Commitments and contingent liabilities | | |
| SHAREHOLDERS' EQUITY: | | |
| Common stock, \$0.50 par value; 350,000,000 shares authorized; 183,872,908 and 186,548,602 shares issued and outstanding as of May 31, 2017 and February 28, 2017, respectively | 91,936 | 93,274 |
| Capital in excess of par value | 1,184,661 | 1,188,578 |
| Accumulated other comprehensive loss | (58,229) | (56,555) |
| Retained earnings | 1,933,760 | 1,883,283 |
| TOTAL SHAREHOLDERS' EQUITY | 3,152,128 | 3,108,580 |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$16,475,689 | \$16,279,356 |

See accompanying notes to consolidated financial statements.

Page 5

CARMAX, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(Unaudited)

| (In thousands) | Three Months Ended | |
|--|--------------------|-------------------|
| | May 31 | |
| | 2017 | 2016 |
| OPERATING ACTIVITIES: | | |
| Net earnings | \$211,702 | \$175,360 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Depreciation and amortization | 43,894 | 40,801 |
| Share-based compensation expense | 18,726 | 31,437 |
| Provision for loan losses | 28,579 | 26,591 |
| Provision for cancellation reserves | 17,113 | 18,692 |
| Deferred income tax provision | 6,782 | 7,374 |
| Other | 621 | 268 |
| Net decrease (increase) in: | | |
| Accounts receivable, net | 47,643 | 29,630 |
| Inventory | 112,316 | 67,038 |
| Other current assets | 5,451 | (4,031) |
| Auto loan receivables, net | (325,347) | (343,067) |
| Other assets | 809 | 399 |
| Net increase (decrease) in: | | |
| Accounts payable, accrued expenses and other current liabilities and accrued income taxes | 52,673 | 69,114 |
| Other liabilities | (29,469) | (31,999) |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | 191,493 | 87,607 |
| INVESTING ACTIVITIES: | | |
| Capital expenditures | (79,416) | (97,463) |
| Increase in restricted cash from collections on auto loan receivables | (5,339) | (20,327) |
| Increase in restricted cash in reserve accounts | (6,308) | (3,101) |
| Release of restricted cash from reserve accounts | 3,344 | 41 |
| Purchases of money market securities, net | (1,824) | (289) |
| Purchases of trading securities | (1,055) | (2,355) |
| Sales of trading securities | 238 | 244 |
| NET CASH USED IN INVESTING ACTIVITIES | (90,360) | (123,250) |
| FINANCING ACTIVITIES: | | |
| Increase in short-term debt, net | 631 | 827 |
| Proceeds from issuances of long-term debt | 762,000 | 1,093,800 |
| Payments on long-term debt | (917,000) | (1,208,800) |
| Cash paid for debt issuance costs | (2,920) | (4,680) |
| Payments on finance and capital lease obligations | (2,268) | (3,040) |
| Issuances of non-recourse notes payable | 2,410,000 | 2,259,000 |
| Payments on non-recourse notes payable | (2,149,135) | (1,952,428) |
| Repurchase and retirement of common stock | (187,385) | (137,989) |
| Equity issuances | 6,608 | 4,134 |
| NET CASH (USED IN) PROVIDED BY FINANCING ACTIVITIES | (79,469) | 50,824 |

Edgar Filing: CARMAX INC - Form 10-Q

| | | |
|---|-----------------|-----------------|
| Increase in cash and cash equivalents | 21,664 | 15,181 |
| Cash and cash equivalents at beginning of year | 38,416 | 37,394 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$60,080 | \$52,575 |

See accompanying notes to consolidated financial statements.

Page 6

CARMAX, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
(Unaudited)

1. Background

CarMax, Inc. (“we,” “our,” “us,” “CarMax” and “the company”), including its wholly owned subsidiaries, is the largest retailer of used vehicles in the United States. We operate in two reportable segments: CarMax Sales Operations and CarMax Auto Finance (“CAF”). Our CarMax Sales Operations segment consists of all aspects of our auto merchandising and service operations, excluding financing provided by CAF. Our CAF segment consists solely of our own finance operation that provides financing to customers buying retail vehicles from CarMax.

We deliver an unrivaled customer experience by offering a broad selection of high quality used vehicles and related products and services at low, no-haggle prices using a customer-friendly sales process in an attractive, modern sales facility, as well as through carmax.com and our mobile apps. We provide customers with a range of related products and services, including the appraisal and purchase of vehicles directly from consumers; the financing of retail vehicle purchases through CAF and third-party finance providers; the sale of extended protection plan (“EPP”) products, which include extended service plans (“ESPs”) and guaranteed asset protection (“GAP”); and vehicle repair service. Vehicles purchased through the appraisal process that do not meet our retail standards are sold to licensed dealers through on-site wholesale auctions.

2. Accounting Policies

Basis of Presentation and Use of Estimates. The accompanying interim unaudited consolidated financial statements include the accounts of CarMax and our wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. These consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles (“GAAP”) for interim financial information. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, such interim consolidated financial statements reflect all normal recurring adjustments considered necessary to present fairly the financial position and the results of operations and cash flows for the interim periods presented. The results of operations for the interim periods are not necessarily indicative of the results to be expected for the full fiscal year. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and footnotes included in our Annual Report on Form 10-K for the fiscal year ended February 28, 2017.

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities. Actual results could differ from those estimates. Certain prior year amounts have been reclassified to conform to the current year’s presentation. Amounts and percentages may not total due to rounding.

In connection with our adoption of the Financial Accounting Standards Board’s (“FASB”) Accounting Standards Update (“ASU”) 2016-09 during the current fiscal year, cash flows related to excess tax benefits from share-based payment arrangements are now classified as operating activities, rather than financing activities, in the consolidated statements of cash flows. Prior period amounts have been reclassified to conform to the current year’s presentation.

Cash and Cash Equivalents. Cash equivalents of approximately \$34.4 million as of May 31, 2017, and \$0.3 million as of February 28, 2017, consisted of highly liquid investments with original maturities of three months or less.

Restricted Cash from Collections on Auto Loan Receivables. Cash equivalents totaling \$385.7 million as of May 31, 2017, and \$380.4 million as of February 28, 2017, consisted of collections of principal, interest and fee payments on auto loan receivables that are restricted for payment to the term securitization and warehouse facility investors pursuant to the applicable agreements.

Financing and Securitization Transactions. We maintain a revolving funding program composed of three warehouse facilities (“warehouse facilities”) that we use to fund auto loan receivables originated by CAF. We typically elect to fund these receivables through a term securitization or alternative funding arrangement at a later date. We sell the auto loan receivables to one of three wholly owned, bankruptcy-remote, special purpose entities that transfer an undivided percentage ownership interest in the receivables, but not the receivables themselves, to entities formed by third-party investors. These entities issue asset-backed commercial paper or utilize other funding sources supported by the transferred receivables, and the proceeds are used to finance the related receivables.

We typically use term securitizations to provide long-term funding for most of the auto loan receivables initially funded through the warehouse facilities. In these transactions, a pool of auto loan receivables is sold to a bankruptcy-remote, special purpose entity that, in turn, transfers the receivables to a special purpose securitization trust. The securitization trust issues asset-backed securities, secured or otherwise supported by the transferred receivables, and the proceeds from the sale of the asset-backed securities are used to finance the securitized receivables.

We are required to evaluate term securitization trusts for consolidation. In our capacity as servicer, we have the power to direct the activities of the trusts that most significantly impact the economic performance of the trusts. In addition, we have the obligation to absorb losses (subject to limitations) and the rights to receive any returns of the trusts, which could be significant. Accordingly, we are the primary beneficiary of the trusts and are required to consolidate them.

We recognize transfers of auto loan receivables into the warehouse facilities and term securitizations (“funding vehicles”) as secured borrowings, which result in recording the auto loan receivables and the related non-recourse notes payable on our consolidated balance sheets.

These receivables can only be used as collateral to settle obligations of the related funding vehicles. The funding vehicles and investors have no recourse to our assets beyond the related receivables, the amounts on deposit in reserve accounts and the restricted cash from collections on auto loan receivables. We have not provided financial or other support to the funding vehicles that was not previously contractually required, and there are no additional arrangements, guarantees or other commitments that could require us to provide financial support to the funding vehicles.

See Notes 4 and 10 for additional information on auto loan receivables and non-recourse notes payable.

Auto Loan Receivables, Net. Auto loan receivables include amounts due from customers related to retail vehicle sales financed through CAF. The receivables are presented net of an allowance for estimated loan losses. The allowance for loan losses represents an estimate of the amount of net losses inherent in our portfolio of managed receivables as of the applicable reporting date and anticipated to occur during the following 12 months. The allowance is primarily based on the credit quality of the underlying receivables, historical loss trends and forecasted forward loss curves. We also take into account recent trends in delinquencies and defaults, recovery rates and the economic environment. The provision for loan losses is the periodic expense of maintaining an adequate allowance.

An account is considered delinquent when the related customer fails to make a substantial portion of a scheduled payment on or before the due date. In general, accounts are charged-off on the last business day of the month during which the earliest of the following occurs: the receivable is 120 days or more delinquent as of the last business day of the month, the related vehicle is repossessed and liquidated, or the receivable is otherwise deemed uncollectible. For purposes of determining impairment, auto loans are evaluated collectively, as they represent a large group of smaller-balance homogeneous loans, and therefore, are not individually evaluated for impairment. See Note 4 for additional information on auto loan receivables.

Interest income and expenses related to auto loans are included in CAF income. Interest income on auto loan receivables is recognized when earned based on contractual loan terms. All loans continue to accrue interest until repayment or charge-off. Direct costs associated with loan originations are not considered material, and thus, are expensed as incurred. See Note 3 for additional information on CAF income.

Property and Equipment. Property and equipment is stated at cost less accumulated depreciation and amortization of \$1.08 billion and \$1.04 billion as of May 31, 2017 and February 28, 2017, respectively.

Other Assets. Other assets includes amounts classified as restricted cash on deposit in reserve accounts and restricted investments. The restricted cash on deposit in reserve accounts is for the benefit of holders of non-recourse notes payable, and these funds are not expected to be available to the company or its creditors. In the event that the cash generated by the related receivables in a given period was insufficient to pay the interest, principal and other required payments, the balances on deposit in the reserve accounts would be used to pay those amounts. Restricted cash on deposit in reserve accounts is invested in money market securities or bank deposit accounts and was \$55.7 million as of May 31, 2017, and \$52.8 million as of February 28, 2017.

Restricted investments includes money market securities primarily held to satisfy certain insurance program requirements, as well as mutual funds held in a rabbi trust established to fund informally our executive deferred compensation plan. Restricted investments totaled \$74.1 million as of May 31, 2017, and \$70.8 million as of February 28, 2017.

Revenue Recognition. We recognize revenue when the earnings process is complete, generally either at the time of sale to a customer or upon delivery to a customer. As part of our customer service strategy, we guarantee the retail vehicles we sell with a 5-day, money-back guarantee. We record a reserve for estimated returns based on historical experience and trends.

We also sell ESP and GAP products on behalf of unrelated third parties, who are the primary obligors, to customers who purchase a retail vehicle. The ESPs we currently offer on all used vehicles provide coverage up to 60 months (subject to mileage limitations), while GAP covers the customer for the term of their finance contract. We recognize revenue, on a net basis, at the time of sale. We also record a reserve for estimated contract cancellations. Periodically, we may receive additional revenue based upon the level of underwriting profits of the third parties who administer the products. These additional amounts are recognized as revenue when received. The reserve for cancellations is evaluated for each product and is based on forecasted forward cancellation curves utilizing historical experience, recent trends and credit mix of the customer base. Our risk related to contract cancellations is limited to the revenue that we receive. Cancellations fluctuate depending on the volume of EPP sales, customer financing default or prepayment rates, and shifts in customer behavior, including those related to changes in the coverage or term of the product. The current portion of estimated cancellation reserves is recognized as a component of accrued expenses and other current liabilities with the remaining amount recognized in other liabilities. See Note 7 for additional information on cancellation reserves.

Customers applying for financing who are not approved or are conditionally approved by CAF are generally evaluated by other third-party finance providers. These providers generally either pay us or are paid a fixed, pre-negotiated fee per contract. We recognize these fees at the time of sale.

We collect sales taxes and other taxes from customers on behalf of governmental authorities at the time of sale. These taxes are accounted for on a net basis and are not included in net sales and operating revenues or cost of sales.

Derivative Instruments and Hedging Activities. We enter into derivative instruments to manage certain risks arising from both our business operations and economic conditions that result in the future known receipt or payment of uncertain cash amounts, the values of which are impacted by interest rates. We recognize the derivatives at fair value as either current assets or current liabilities on the consolidated balance sheets, and where applicable, such contracts covered by master netting agreements are reported net. Gross positive fair values are netted with gross negative fair values by counterparty. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether we have elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. We may enter into derivative contracts that are intended to economically hedge certain risks, even though hedge accounting may not apply or we do not elect to apply hedge accounting. See Note 5 for additional information on derivative instruments and hedging activities.

Recent Accounting Pronouncements.
Effective in the Current Period.

In July 2015, the FASB issued an accounting pronouncement (FASB ASU 2015-11), which simplifies the subsequent measurement of inventory by replacing the lower of cost or market test with a lower of cost or net realizable value (“NRV”) test. NRV is calculated as the estimated selling price less reasonably predictable costs of completion, disposal and transportation. We adopted this pronouncement for our fiscal year beginning March 1, 2017, and it did not have a material effect on our consolidated financial statements.

In March 2016, the FASB issued an accounting pronouncement (FASB ASU 2016-09) related to simplifications of employee share-based payment accounting. This pronouncement eliminates the APIC pool concept and requires that excess tax benefits and tax deficiencies be recorded in the income statement when awards are settled. The standard

also addresses simplifications related to statement of cash flows classification, accounting for forfeitures, and minimum statutory tax withholding requirements. We adopted this pronouncement for our fiscal year beginning March 1, 2017. The requirements related to the tax consequences of share-based payments were applied prospectively and resulted in \$2.4 million recorded as a reduction to the income tax provision during the three months ended May 31, 2017. The provisions related to the presentation of excess tax benefits on the consolidated statements of cash flows were applied retrospectively, resulting in an increase in cash provided by operating activities and a decrease in cash provided by financing activities of \$2.2 million for the three months ended May 31, 2016. We elected to continue estimating forfeitures of share-based awards, and none of the other provisions of the pronouncement had a material effect on our consolidated financial statements.

Effective in Future Periods.

In May 2014, the FASB issued an accounting pronouncement (FASB ASU 2014-09) related to revenue recognition. This ASU, along with subsequent ASUs issued to clarify certain provisions and the effective date of ASU 2014-09, provides a single, comprehensive revenue recognition model for all contracts with customers. The standard contains principles that an entity will apply to determine the measurement of revenue and the timing of when it is recognized. The entity will recognize revenue to

reflect the transfer of goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. This standard will become effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. ASU 2014-09 may be adopted using either a full retrospective method, which requires a restatement of prior periods presented, or a modified retrospective method with the cumulative effect of applying the standard recognized at the date of adoption. We will adopt this standard for our fiscal year beginning March 1, 2018.

While we continue to assess all potential impacts of this standard, we generally do not expect adoption of the standard to have a material impact on our consolidated financial statements. We primarily sell products and recognize revenue at the point of sale or delivery to customers, at which point the earnings process is deemed to be complete. Our performance obligations are clearly identifiable and we do not anticipate significant changes to the assessment of such performance obligations or the timing of our revenue recognition upon adoption of the new standard. Our primary business processes are consistent with the principles contained in the ASU, and we do not expect significant changes to those processes, our internal controls or systems. The standard is expected to have an impact on the way we account for sales returns on our consolidated balance sheets. We are still evaluating the impact of the new standard on our financial statement disclosures as well as our planned transition approach.

In February 2016, the FASB issued an accounting pronouncement (FASB ASU 2016-02) related to the accounting for leases. This pronouncement requires lessees to record most leases on their balance sheet while also disclosing key information about those lease arrangements. Under the new guidance, lease classification as either a finance lease or an operating lease will affect the pattern and classification of expense recognition in the income statement. The classification criteria to distinguish between finance and operating leases are generally consistent with the classification criteria to distinguish between capital and operating leases under existing lease accounting guidance. This pronouncement is effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2018. We expect to adopt the new standard for our fiscal year beginning March 1, 2019. A modified retrospective transition approach is required for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with practical expedients available for election as a package.

We expect that this standard will have a material effect on our consolidated balance sheets as a result of recognizing new right-of-use assets and lease liabilities for existing operating leases. To date, we have not completed our comprehensive analysis of those leases and are unable to quantify the impact at this time. We are still evaluating the impact of the standard on our sale-leaseback transactions currently accounted for as direct financings. We believe that the majority of our leases will maintain their current lease classification under the new standard. As a result, we do not expect the new standard to have a material effect on our expense recognition pattern or, in turn, our consolidated statements of operations. We are continuing to evaluate the full impact of the new standard, as well as its impacts on our business processes, systems, and internal controls.

In May 2017, the FASB issued an accounting pronouncement (FASB ASU 2017-09) to provide guidance on determining which changes to the terms or conditions of share-based payment awards require an entity to apply modification accounting under Accounting Standards Codification Topic 718. This pronouncement is effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2017, with early adoption permitted, and is applied prospectively to changes in terms or conditions of awards occurring on or after the adoption date. We plan to adopt this pronouncement for our fiscal year beginning March 1, 2018 and will consider the impact that this standard may have on future share-based payment award changes, should they occur.

3. CarMax Auto Finance

CAF provides financing to qualified retail customers purchasing vehicles from CarMax. CAF provides us the opportunity to capture additional profits, cash flows and sales while managing our reliance on third-party finance

sources. Management regularly analyzes CAF's operating results by assessing profitability, the performance of the auto loan receivables including trends in credit losses and delinquencies, and CAF direct expenses. This information is used to assess CAF's performance and make operating decisions, including resource allocation.

We typically use securitizations to fund loans originated by CAF, as discussed in Note 2. CAF income primarily reflects the interest and fee income generated by the auto loan receivables less the interest expense associated with the debt issued to fund these receivables, a provision for estimated loan losses and direct CAF expenses.

CAF income does not include any allocation of indirect costs. Although CAF benefits from certain indirect overhead expenditures, we have not allocated indirect costs to CAF to avoid making subjective allocation decisions. Examples of indirect costs not allocated to CAF include retail store expenses and corporate expenses. In addition, except for auto loan receivables, which are disclosed in Note 4, CAF assets are not separately reported nor do we allocate assets to CAF because such allocation would not be useful to management in making operating decisions.

Components of CAF Income

| (In millions) | Three Months Ended May 31 | | | |
|---|---------------------------|------------------|-----------|------------------|
| | 2017 | % ⁽¹⁾ | 2016 | % ⁽¹⁾ |
| Interest margin: | | | | |
| Interest and fee income | \$206.7 | 7.6 | \$184.1 | 7.6 |
| Interest expense | (49.0) | (1.8) | (39.4) | (1.6) |
| Total interest margin | 157.7 | 5.8 | 144.7 | 5.9 |
| Provision for loan losses | (28.6) | (1.1) | (26.6) | (1.1) |
| Total interest margin after provision for loan losses | 129.1 | 4.8 | 118.1 | 4.8 |
| Direct expenses: | | | | |
| Payroll and fringe benefit expense | (8.5) | (0.3) | (7.6) | (0.3) |
| Other direct expenses | (11.2) | (0.4) | (9.7) | (0.4) |
| Total direct expenses | (19.7) | (0.7) | (17.3) | (0.7) |
| CarMax Auto Finance income | \$109.4 | 4.0 | \$100.8 | 4.1 |
| Total average managed receivables | \$10,829.5 | | \$9,745.0 | |

⁽¹⁾ Annualized percentage of total average managed receivables.

4. Auto Loan Receivables

Auto loan receivables include amounts due from customers related to retail vehicle sales financed through CAF and are presented net of an allowance for estimated loan losses. We generally use warehouse facilities to fund auto loan receivables originated by CAF until we elect to fund them through a term securitization or alternative funding arrangement. The majority of the auto loan receivables serve as collateral for the related non-recourse notes payable of \$11.00 billion as of May 31, 2017 and \$10.74 billion as of February 28, 2017. See Notes 2 and 10 for additional information on securitizations and non-recourse notes payable.

Auto Loan Receivables, Net

| (In millions) | As of May | As of |
|--|------------|------------|
| | 31 | February |
| | 2017 | 2017 |
| Term securitizations | \$8,642.5 | \$8,784.7 |
| Warehouse facilities | 2,022.0 | 1,624.0 |
| Overcollateralization ⁽¹⁾ | 233.7 | 211.4 |
| Other managed receivables ⁽²⁾ | 85.1 | 61.2 |
| Total ending managed receivables | 10,983.3 | 10,681.3 |
| Accrued interest and fees | 45.3 | 38.5 |
| Other | (6.0) | (0.1) |
| Less allowance for loan losses | (129.8) | (123.6) |
| Auto loan receivables, net | \$10,892.8 | \$10,596.1 |

⁽¹⁾ Represents receivables restricted as excess collateral for the warehouse facilities and term securitizations.

⁽²⁾ Other managed receivables includes receivables not funded through the warehouse facilities or term securitizations.

Credit Quality. When customers apply for financing, CAF's proprietary scoring models rely on the customers' credit history and certain application information to evaluate and rank their risk. We obtain credit histories and other credit data that includes information such as number, age, type of and payment history for prior or existing credit accounts. The application information that is used includes income, collateral value and down payment. The scoring models yield credit grades that represent the relative likelihood of repayment. Customers assigned a grade of "A" are determined to have the highest probability of repayment, and

customers assigned a lower grade are determined to have a lower probability of repayment. For loans that are approved, the credit grade influences the terms of the agreement, such as the required loan-to-value ratio and interest rate.

CAF uses a combination of the initial credit grades and historical performance to monitor the credit quality of the auto loan receivables on an ongoing basis. We validate the accuracy of the scoring models periodically. Loan performance is reviewed on a recurring basis to identify whether the assigned grades adequately reflect the customers' likelihood of repayment.

Ending Managed Receivables by Major Credit Grade

| (In millions) | As of May 31 | | As of February 28 | |
|----------------------------------|---------------------|------------------|---------------------|------------------|
| | 2017 ⁽¹⁾ | % ⁽²⁾ | 2017 ⁽¹⁾ | % ⁽²⁾ |
| A | \$5,362.5 | 48.8 | \$5,223.4 | 48.9 |
| B | 3,878.0 | 35.3 | 3,739.4 | 35.0 |
| C and other | 1,742.8 | 15.9 | 1,718.5 | 16.1 |
| Total ending managed receivables | \$10,983.3 | 100.0 | \$10,681.3 | 100.0 |

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

(2) Percent of total ending managed receivables.

Allowance for Loan Losses

| (In millions) | Three Months Ended May 31 | | | |
|-----------------------------------|---------------------------|------------------|---------|------------------|
| | 2017 | % ⁽¹⁾ | 2016 | % ⁽¹⁾ |
| Balance as of beginning of period | \$123.6 | 1.16 | \$94.9 | 0.99 |
| Charge-offs | (54.1) | | (45.8) | |
| Recoveries | 31.7 | | 28.3 | |
| Provision for loan losses | 28.6 | | 26.6 | |
| Balance as of end of period | \$129.8 | 1.18 | \$104.0 | 1.05 |

(1) Percent of total ending managed receivables.

The allowance for loan losses represents an estimate of the amount of net losses inherent in our portfolio of managed receivables as of the applicable reporting date and anticipated to occur during the following 12 months. The allowance is primarily based on the credit quality of the underlying receivables, historical loss trends and forecasted forward loss curves. We also take into account recent trends in delinquencies and defaults, recovery rates and the economic environment. The provision for loan losses is the periodic expense of maintaining an adequate allowance.

Past Due Receivables

| (In millions) | As of May 31 | | As of February 28 | |
|----------------------------------|--------------|------------------|-------------------|------------------|
| | 2017 | % ⁽¹⁾ | 2017 | % ⁽¹⁾ |
| Total ending managed receivables | \$10,983.3 | 100.0 | \$10,681.3 | 100.0 |
| Delinquent loans: | | | | |
| 31-60 days past due | \$219.7 | 2.0 | \$211.0 | 2.0 |
| 61-90 days past due | 91.7 | 0.8 | 93.5 | 0.9 |
| Greater than 90 days past due | 27.0 | 0.3 | 26.5 | 0.2 |
| Total past due | \$338.4 | 3.1 | \$331.0 | 3.1 |

(1) Percent of total ending managed receivables.

Page 12

5. Derivative Instruments and Hedging Activities

We use derivatives to manage certain risks arising from both our business operations and economic conditions, particularly with regard to issuances of debt. Primary exposures include LIBOR and other rates used as benchmarks in our securitizations and other debt financing. We enter into derivative instruments to manage exposures related to the future known receipt or payment of uncertain cash amounts, the values of which are impacted by interest rates, and designate these derivative instruments as cash flow hedges for accounting purposes. Our derivative instruments are used to manage (i) differences in the amount of our known or expected cash receipts and our known or expected cash payments principally related to the funding of our auto loan receivables, and (ii) exposure to variable interest rates associated with our term loan, as further discussed in Note 10.

For the derivatives associated with our securitization program, the effective portion of changes in the fair value is initially recorded in accumulated other comprehensive loss (“AOCL”). For the majority of these derivatives, the amounts are subsequently reclassified into CAF income in the period that the hedged forecasted transaction affects earnings, which occurs as interest expense is recognized on those future issuances of debt. During the next 12 months, we estimate that an additional \$3.7 million will be reclassified from AOCL as a decrease to CAF income.

As of May 31, 2017 and February 28, 2017, we had interest rate swaps outstanding with a combined notional amount of \$2.22 billion and \$2.03 billion, respectively, that were designated as cash flow hedges of interest rate risk.

Fair Values of Derivative Instruments

| (In thousands) | As of May 31, 2017 | | As of February 28, 2017 | |
|--|-----------------------|-----------------|----------------------------|-----------------|
| | Assets (1) | Liabilities (2) | Assets (1) | Liabilities (2) |
| Derivatives designated as accounting hedges: | | | | |
| Interest rate swaps | \$577 | \$ (3,739) | \$2,997 | \$ (509) |

(1) Reported in other current assets on the consolidated balance sheets.

(2) Reported in accounts payable on the consolidated balance sheets.

Effect of Derivative Instruments on Comprehensive Income

| (In thousands) | Three Months Ended May 31 | |
|---|---------------------------------|------------|
| | 2017 | 2016 |
| Derivatives designated as accounting hedges: | | |
| (Loss) gain recognized in AOCL (1) | \$ (4,226) | \$ 2,331 |
| Loss reclassified from AOCL into CAF income (1) | \$ (1,013) | \$ (2,813) |

(1) Represents the effective portion.

6. Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the principal market or, if none exists, the most advantageous market, for the specific asset or liability at the measurement date (referred to as the “exit price”). The fair value should be based on assumptions that market participants would use, including a consideration of nonperformance risk.

We assess the inputs used to measure fair value using the three-tier hierarchy. The hierarchy indicates the extent to which inputs used in measuring fair value are observable in the market.

Level 1 Inputs include unadjusted quoted prices in active markets for identical assets or liabilities that we can access at the measurement date.

Level 2 Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, including quoted prices for similar assets in active markets, quoted prices from identical or similar assets in inactive markets and observable inputs such as interest rates and yield curves.

Level 3 Inputs that are significant to the measurement that are not observable in the market and include management's judgments about the assumptions market participants would use in pricing the asset or liability (including assumptions about risk).

Our fair value processes include controls that are designed to ensure that fair values are appropriate. Such controls include model validation, review of key model inputs, analysis of period-over-period fluctuations and reviews by senior management.

Valuation Methodologies

Money Market Securities. Money market securities are cash equivalents, which are included in cash and cash equivalents, restricted cash from collections on auto loan receivables or other assets. They consist of highly liquid investments with original maturities of three months or less and are classified as Level 1.

Mutual Fund Investments. Mutual fund investments consist of publicly traded mutual funds that primarily include diversified investments in large-, mid- and small-cap domestic and international companies. The investments, which are included in other assets, are held in a rabbi trust established to fund informally our executive deferred compensation plan and are classified as Level 1.

Derivative Instruments. The fair values of our derivative instruments are included in either other current assets or accounts payable. As described in Note 5, as part of our risk management strategy, we utilize derivative instruments to manage differences in the amount of our known or expected cash receipts and our known or expected cash payments principally related to the funding of our auto loan receivables as well as to manage exposure to variable interest rates on our term loan. Our derivatives are not exchange-traded and are over-the-counter customized derivative instruments. All of our derivative exposures are with highly rated bank counterparties.

We measure derivative fair values assuming that the unit of account is an individual derivative instrument and that derivatives are sold or transferred on a stand-alone basis. We estimate the fair value of our derivatives using quotes determined by the derivative counterparties and third-party valuation services. Quotes from third-party valuation services and quotes received from bank counterparties project future cash flows and discount the future amounts to a present value using market-based expectations for interest rates and the contractual terms of the derivative instruments. The models do not require significant judgment and model inputs can typically be observed in a liquid market; however, because the models include inputs other than quoted prices in active markets, all derivatives are classified as Level 2.

Our derivative fair value measurements consider assumptions about counterparty and our own nonperformance risk. We monitor counterparty and our own nonperformance risk and, in the event that we determine that a party is unlikely to perform under terms of the contract, we would adjust the derivative fair value to reflect the nonperformance risk.

Items Measured at Fair Value on a Recurring Basis

| (In thousands) | As of May 31, 2017 | | Total |
|----------------------------|--------------------|---------|-----------|
| | Level 1 | Level 2 | |
| Assets: | | | |
| Money market securities | \$410,764 | \$— | \$410,764 |
| Mutual fund investments | 17,813 | — | 17,813 |
| Derivative instruments | — | 577 | 577 |
| Total assets at fair value | \$428,577 | \$577 | \$429,154 |

Edgar Filing: CARMAX INC - Form 10-Q

| | | | | |
|---------------------------------------|------|-------|---------|---|
| Percent of total assets at fair value | 99.9 | % 0.1 | % 100.0 | % |
| Percent of total assets | 2.6 | % — | % 2.6 | % |

Liabilities:

| | | | | |
|---------------------------------|-----|-----------|-----------|---|
| Derivative instruments | \$— | \$(3,739) | \$(3,739) |) |
| Total liabilities at fair value | \$— | \$(3,739) | \$(3,739) |) |

| | | | | |
|------------------------------|---|-----|-----|---|
| Percent of total liabilities | — | % — | % — | % |
|------------------------------|---|-----|-----|---|

Page 14

| (In thousands) | As of February 28, 2017 | | | |
|---------------------------------------|-------------------------|----------|-----------|---|
| | Level 1 | Level 2 | Total | |
| Assets: | | | | |
| Money market securities | \$397,994 | \$— | \$397,994 | |
| Mutual fund investments | 16,519 | — | 16,519 | |
| Derivative instruments | — | 2,997 | 2,997 | |
| Total assets at fair value | \$414,513 | \$2,997 | \$417,510 | |
| Percent of total assets at fair value | 99.3 | % 0.7 | % 100.0 | % |
| Percent of total assets | 2.5 | % — | % 2.6 | % |
| Liabilities: | | | | |
| Derivative instruments | \$— | \$(509) | \$(509) | |
| Total liabilities at fair value | \$— | \$(509) | \$(509) | |
| Percent of total liabilities | — | % — | % — | % |

There were no transfers between Levels 1 and 2 for the three months ended May 31, 2017. As of May 31, 2017 and February 28, 2017 we had no Level 3 assets.

Fair Value of Financial Instruments

The carrying value of our cash and cash equivalents, accounts receivable, other restricted cash deposits and accounts payable approximates fair value due to the short-term nature and/or variable rates associated with these financial instruments. Auto loan receivables are presented net of an allowance for estimated loan losses. We believe that the carrying value of our revolving credit facility and term loan approximates fair value due to the variable rates associated with these obligations. The fair value of our senior unsecured notes, which are not carried at fair value on our consolidated balance sheets, was determined using Level 2 inputs based on quoted market prices. The carrying value and fair value of the senior unsecured notes as of May 31, 2017 and February 28, 2017, respectively, are as follows:

| (In thousands) | As of May 31, 2017 | As of February 28, 2017 |
|----------------|--------------------------|-------------------------------|
| Carrying value | \$500,000 | \$500,000 |
| Fair value | \$509,255 | \$499,518 |

7. Cancellation Reserves

We recognize revenue for EPP products, on a net basis, at the time of sale. We also record a reserve for estimated contract cancellations. Cancellations of these services may result from early termination by the customer, or default or prepayment on the finance contract. The reserve for cancellations is evaluated for each product, and is based on forecasted forward cancellation curves utilizing historical experience, recent trends and credit mix of the customer base.

Cancellation Reserves

| (In millions) | Three Months Ended May 31 | |
|-----------------------------------|------------------------------|---------|
| | 2017 | 2016 |
| Balance as of beginning of period | \$108.2 | \$110.2 |
| Cancellations | (16.3) | (16.4) |

| | | |
|------------------------------------|---------|---------|
| Provision for future cancellations | 17.1 | 18.7 |
| Balance as of end of period | \$109.0 | \$112.5 |

The current portion of estimated cancellation reserves is recognized as a component of accrued expenses and other current liabilities with the remaining amount recognized in other liabilities. As of May 31, 2017 and February 28, 2017, the current portion of cancellation reserves was \$56.9 million and \$56.4 million, respectively.

8. Income Taxes

We had \$29.9 million of gross unrecognized tax benefits as of May 31, 2017, and \$30.0 million as of February 28, 2017. There were no significant changes to the gross unrecognized tax benefits as reported for the year ended February 28, 2017, as all activity was related to positions taken on tax returns previously filed or intended to be filed in the current fiscal year.

9. Retirement Benefit Plans

We have two frozen noncontributory defined benefit plans: our pension plan (the “pension plan”) and our unfunded, nonqualified plan (the “restoration plan”), which restores retirement benefits for certain associates who are affected by Internal Revenue Code limitations on benefits provided under the pension plan. No additional benefits have accrued under these plans since they were frozen; however, we have a continuing obligation to fund the pension plan and will continue to recognize net periodic pension expense for both plans for benefits earned prior to being frozen. We use a fiscal year end measurement date for both the pension plan and the restoration plan.

Net Pension Expense

| | Three Months Ended May 31 | | | | | |
|---------------------|---------------------------|-------|------------------|-------|-------|-------|
| | Pension Plan | | Restoration Plan | | Total | |
| (In thousands) | 2017 | 2016 | 2017 | 2016 | 2017 | 2016 |
| Net pension expense | \$52 | \$ 82 | \$117 | \$120 | \$169 | \$202 |

Net pension expense includes actuarial loss amortization of \$0.5 million and \$0.4 million for the three months ended May 31, 2017 and 2016, respectively. We made no contributions to the pension plan during the three months ended May 31, 2017. We expect to make contributions of \$2.1 million to the pension plan during the remainder of fiscal 2018. The expected long-term rate of return on plan assets for the pension plan was 7.75% as of February 28, 2017.

10. Debt

| | As of May 31 | As of February 28 |
|---------------------------------------|--------------|-------------------|
| (In thousands) | 2017 | 2017 |
| Revolving credit facility | \$693 | \$155,062 |
| Term loan | 300,000 | 300,000 |
| 3.86% Senior notes due 2023 | 100,000 | 100,000 |
| 4.17% Senior notes due 2026 | 200,000 | 200,000 |
| 4.27% Senior notes due 2028 | 200,000 | 200,000 |
| Finance and capital lease obligations | 494,166 | 496,136 |
| Non-recourse notes payable | 11,003,290 | 10,742,425 |
| Total debt | 12,298,149 | 12,193,623 |
| Less: current portion | (349,297) | (343,266) |
| Less: unamortized debt issuance costs | (22,982) | (23,919) |
| Long-term debt, net | \$11,925,870 | \$11,826,438 |

Revolving Credit Facility. We have a \$1.20 billion unsecured revolving credit facility (the “credit facility”) with various financial institutions that expires in August 2020. Borrowings under the credit facility are available for working capital and general corporate purposes. Borrowings accrue interest at variable rates based on LIBOR, the federal funds rate, or the prime rate, depending on the type of borrowing, and we pay a commitment fee on the unused

portions of the available funds. Borrowings under the credit facility are either due “on demand” or at maturity depending on the type of borrowing. Borrowings with “on demand” repayment terms are presented as short-term debt, while amounts due at maturity are presented as long-term debt with expected repayments within the next 12 months presented as a component of current portion of long-term debt. As of May 31, 2017, the unused capacity of \$1,199.3 million was fully available to us.

Term Loan. We have a \$300 million term loan that expires in August 2020. The term loan accrues interest at variable rates based on the LIBOR rate, the federal funds rate, or the prime rate, and interest is payable monthly. As of May 31, 2017, \$300 million remained outstanding and was classified as long-term debt, as no repayments are scheduled to be made within the next 12 months. Borrowings under the term loan are available for working capital and general corporate purposes. We have entered into an interest rate derivative contract, which will expire in November 2017, to manage our exposure to variable interest rates associated with this term loan.

Senior Notes. We have senior unsecured notes with outstanding principal totaling \$500 million as of May 31, 2017, which are due in 2023, 2026 and 2028. These notes were classified as long-term debt as no repayments are scheduled to be made within the next 12 months. Borrowings under these notes are available for working capital and general corporate purposes. Interest on the notes is payable semi-annually.

Finance and Capital Lease Obligations. Finance and capital lease obligations relate primarily to stores subject to sale-leaseback transactions that did not qualify for sale accounting, and therefore, are accounted for as financings. The leases were structured at varying interest rates and generally have initial lease terms ranging from 15 to 20 years with payments made monthly. Payments on the leases are recognized as interest expense and a reduction of the obligations. We have not entered into any new sale-leaseback transactions since fiscal 2009. In the event the leases are modified or extended beyond their original lease term, the related obligation is increased based on the present value of the revised future lease payments, with a corresponding increase to the assets subject to these transactions. Upon modification, the amortization of the obligation is reset, resulting in more of the lease payments being applied to interest expense in the initial years following the modification. See Note 14 for additional information on finance and capital lease obligations.

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

As of May 31, 2017, \$8.98 billion of non-recourse notes payable was outstanding related to term securitizations. These notes payable accrue interest predominantly at fixed rates and have scheduled maturities through October 2023, but may mature earlier, depending upon the repayment rate of the underlying auto loan receivables.

As of May 31, 2017, \$2.02 billion of non-recourse notes payable was outstanding related to our warehouse facilities. As of May 31, 2017, the combined warehouse facility limit was \$2.80 billion, and the unused warehouse capacity totaled \$778.0 million. Of the combined warehouse facility limit, \$1.30 billion will expire in August 2017 and \$1.50 billion will expire in February 2018. The return requirements of warehouse facility investors could fluctuate significantly depending on market conditions. At renewal, the cost, structure and capacity of the facilities could change. These changes could have a significant impact on our funding costs.

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

Capitalized Interest. We capitalize interest in connection with the construction of certain facilities. For the three months ended May 31, 2017 and 2016, we capitalized interest of \$1.7 million and \$2.6 million, respectively.

Financial Covenants. The credit facility, term loan and senior note agreements contain representations and warranties, conditions and covenants. We must also meet financial covenants in conjunction with certain of the sale-leaseback transactions. Our securitization and warehouse facility agreements contain representations and warranties, financial covenants and performance triggers. As of May 31, 2017, we were in compliance with all financial covenants and our

term securitizations and warehouse facilities were in compliance with the related performance triggers.

11. Stock and Stock-Based Incentive Plans

(A) Share Repurchase Program

As of May 31, 2017, our board of directors has authorized the repurchase of up to \$4.55 billion of our common stock. At that date, \$1.41 billion was available for repurchase, with no expiration date, under the board's outstanding authorization.

Common Stock Repurchases

| | Three Months Ended May 31 | |
|---|---------------------------------|-----------|
| | 2017 | 2016 |
| Number of shares repurchased (in thousands) | 3,034.7 | 2,569.6 |
| Average cost per share | \$60.00 | \$51.39 |
| Available for repurchase, as of end of period (in millions) | \$1,408.3 | \$1,266.0 |

(B) Stock Incentive Plans

We maintain long-term incentive plans for management, certain employees and the nonemployee members of our board of directors. The plans allow for the granting of equity-based compensation awards, including nonqualified stock options, incentive stock options, stock appreciation rights, restricted stock awards, stock- and cash-settled restricted stock units, stock grants or a combination of awards. To date, we have not awarded any incentive stock options.

The majority of associates who receive share-based compensation awards primarily receive cash-settled restricted stock units. Senior management and other key associates receive awards of nonqualified stock options, stock-settled restricted stock units and/or restricted stock awards. Nonemployee directors receive awards of nonqualified stock options, stock grants and/or restricted stock awards. Excluding stock grants, all share-based compensation awards, including any associated dividend rights, are subject to forfeiture.

Nonqualified Stock Options. Nonqualified stock options are awards that allow the recipient to purchase shares of our common stock at a fixed price. Stock options are granted at an exercise price equal to the fair market value of our common stock on the grant date. The stock options generally vest annually in equal amounts over 4 years. These options expire 7 years after the date of the grant.

Cash-Settled Restricted Stock Units. Also referred to as restricted stock units, or RSUs, these are restricted stock unit awards that entitle the holder to a cash payment equal to the fair market value of a share of our common stock for each unit granted. Conversion generally occurs at the end of a three-year vesting period. However, the cash payment per RSU will not be greater than 200% or less than 75% of the fair market value of a share of our common stock on the grant date. RSUs are liability awards and do not have voting rights.

Stock-Settled Market Stock Units. Also referred to as market stock units, or MSUs, these are restricted stock unit awards with market conditions granted to eligible key associates that are converted into between zero and two shares of common stock for each unit granted. Conversion generally occurs at the end of a three-year vesting period. The conversion ratio is calculated by dividing the average closing price of our stock during the final 40 trading days of the three-year vesting period by our stock price on the grant date, with the resulting quotient capped at two. This quotient is then multiplied by the number of MSUs granted to yield the number of shares awarded. MSUs do not have voting rights.

Stock-Settled Performance Stock Units. Also referred to as performance stock units, or PSUs, these are restricted stock unit awards with performance conditions granted to eligible key associates that are converted into between zero and two shares of common stock for each unit granted. Conversion generally occurs at the end of a three-year vesting period. For grants prior to fiscal 2018, the conversion ratio is based on the company reaching certain target levels set by the board of directors for cumulative three-year earnings before interest and taxes at the end of the three-year period. For the fiscal 2018 grants, the conversion ratio is based on reaching certain target levels set by the board of directors for cumulative three-year diluted earnings per share as adjusted to exclude income taxes. The resulting quotients are subject to meeting a minimum 25% threshold and capped at 200%. These quotients are then multiplied by the number of PSUs granted to yield the number of shares awarded. PSUs do not have voting rights.

Restricted Stock Awards. Restricted stock awards (RSAs) are awards of our common stock that are subject to specified restrictions that generally lapse after a one- to three-year period from date of grant. Participants holding restricted stock are entitled to vote on matters submitted to holders of our common stock for a vote.

(C) Share-Based Compensation

Composition of Share-Based Compensation Expense

| (In thousands) | Three Months Ended | |
|---|--------------------|----------|
| | 2017 | 2016 |
| Cost of sales | \$227 | \$1,360 |
| CarMax Auto Finance income | 820 | 904 |
| Selling, general and administrative expenses | 18,093 | 29,583 |
| Share-based compensation expense, before income taxes | \$19,140 | \$31,847 |

Composition of Share-Based Compensation Expense – By Grant Type

| (In thousands) | Three Months Ended | |
|---|--------------------|----------|
| | 2017 | 2016 |
| Nonqualified stock options | \$10,370 | \$13,131 |
| Cash-settled restricted stock units | 3,118 | 12,376 |
| Stock-settled market stock units | 3,621 | 3,650 |
| Stock-settled performance stock units | 1,353 | 2,133 |
| Employee stock purchase plan | 414 | 410 |
| Restricted stock awards | 264 | 147 |
| Share-based compensation expense, before income taxes | \$19,140 | \$31,847 |

Unrecognized Share--Based Compensation Expense – By Grant Type

| (Costs in millions) | As of May 31, 2017 | |
|---------------------------------------|---------------------------------|---|
| | Unrecognized Compensation Costs | Weighted Average Remaining Recognition Life (Years) |
| Nonqualified stock options | \$53.6 | 2.8 |
| Stock-settled market stock units | 17.7 | 1.9 |
| Stock-settled performance stock units | 5.3 | 1.9 |
| Restricted stock | 0.3 | 1.2 |
| Total | \$76.9 | 2.5 |

We recognize compensation expense for stock options, MSUs, PSUs and RSAs on a straight-line basis (net of estimated forfeitures) over the requisite service period, which is generally the vesting period of the award. The PSU expense is adjusted for any change in management's assessment of the performance target level that is probable of being achieved. The variable expense associated with RSUs is recognized over their vesting period (net of estimated forfeitures) and is calculated based on the volume-weighted average price of our common stock on the last trading day of each reporting period.

The total costs for matching contributions for our employee stock purchase plan are included in share-based compensation expense. There were no capitalized share-based compensation costs as of or for the three months ended May 31, 2017 or 2016.

Stock Option Activity

| (Shares and intrinsic value in thousands) | Number of Shares | Weighted Average Remaining Contractual | | Aggregate Intrinsic Value |
|---|------------------|--|--------------|---------------------------|
| | | Exercise Price | Life (Years) | |
| Outstanding as of February 28, 2017 | 7,753 | \$50.00 | | |
| Options granted | 1,930 | 58.38 | | |
| Options exercised | (158) | 39.64 | | |
| Options cancelled | (5) | 62.05 | | |
| Outstanding as of May 31, 2017 | 9,520 | \$51.86 | 4.8 | \$ 119,287 |
| Exercisable as of May 31, 2017 | 4,647 | \$46.55 | 3.5 | \$ 83,119 |

Stock Option Information

| | Three Months Ended May 31 | |
|--|---------------------------|-----------|
| | 2017 | 2016 |
| Options granted | 1,930,362 | 1,547,718 |
| Weighted average grant date fair value per share | \$16.11 | \$ 14.19 |
| Cash received from options exercised (in millions) | \$6.6 | \$ 4.1 |
| Intrinsic value of options exercised (in millions) | \$3.2 | \$ 4.9 |
| Realized tax benefits (in millions) | \$1.3 | \$ 1.9 |

For stock options, the fair value of each award is estimated as of the date of grant using a binomial valuation model. In computing the value of the option, the binomial model considers characteristics of fair-value option pricing that are not available for consideration under a closed-form valuation model (for example, the Black-Scholes model), such as the contractual term of the option, the probability that the option will be exercised prior to the end of its contractual life and the probability of termination or retirement of the option holder. For this reason, we believe that the binomial model provides a fair value that is more representative of actual experience and future expected experience than the value calculated using a closed-form model. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by the recipients of share-based awards.

Assumptions Used to Estimate Option Values

| | Three Months Ended May 31 | |
|---|---------------------------|-------------|
| | 2017 | 2016 |
| Dividend yield | 0.0 % | 0.0 % |
| Expected volatility factor ⁽¹⁾ | 29.4%–32.7% | 30.4%–33.9% |
| Weighted average expected volatility | 29.8% | 30.8% |
| Risk-free interest rate ⁽²⁾ | 0.7 %–2.1 % | 0.2 %–1.6 % |
| Expected term (in years) ⁽³⁾ | 4.6 | 4.6 |

⁽¹⁾ Measured using historical daily price changes of our stock for a period corresponding to the term of the options and the implied volatility derived from the market prices of traded options on our stock.

⁽²⁾ Based on the U.S. Treasury yield curve at the time of grant.

⁽³⁾ Represents the estimated number of years that options will be outstanding prior to exercise.

Cash-Settled Restricted Stock Unit Activity

| | | Weighted Average |
|-------------------------------------|--------------|---------------------|
| | Number of | Grant Date |
| (Units in thousands) | Units | Fair Value |
| Outstanding as of February 28, 2017 | 1,406 | \$ 55.05 |
| Stock units granted | 627 | \$ 58.38 |
| Stock units vested and converted | (459) | \$ 45.00 |
| Stock units cancelled | (17) | \$ 57.11 |
| Outstanding as of May 31, 2017 | 1,557 | \$ 59.33 |

Cash-Settled Restricted Stock Unit Information

| | Three Months Ended May 31 | |
|---|------------------------------|----------|
| | 2017 | 2016 |
| Stock units granted | 627,127 | 631,907 |
| Initial weighted average grant date fair value per share | \$58.38 | \$ 51.63 |
| Payments (before payroll tax withholdings) upon vesting (in millions) | \$25.9 | \$ 22.9 |
| Realized tax benefits (in millions) | \$10.4 | \$ 9.0 |

Expected Cash Settlement Range Upon Restricted Stock Unit Vesting

| | As of May 31, 2017 | |
|---------------------------------|--------------------|------------------------|
| (In thousands) | Minimum | Maximum ⁽¹⁾ |
| Fiscal 2019 | \$18,443 | \$ 49,182 |
| Fiscal 2020 | 19,776 | 52,735 |
| Fiscal 2021 | 22,360 | 59,626 |
| Total expected cash settlements | \$60,579 | \$ 161,543 |

⁽¹⁾ Net of estimated forfeitures.

Stock-Settled Market Stock Unit Activity

| | | Weighted Average |
|-------------------------------------|--------------|---------------------|
| | Number of | Grant Date |
| (Units in thousands) | Units | Fair Value |
| Outstanding as of February 28, 2017 | 504 | \$ 65.74 |
| Stock units granted | 159 | \$ 73.58 |
| Stock units vested and converted | (221) | \$ 55.42 |
| Stock units cancelled | (2) | \$ 74.76 |
| Outstanding as of May 31, 2017 | 440 | \$ 73.72 |

Stock-Settled Market Stock Unit Information

| Three Months Ended May 31 | |
|------------------------------|------|
| 2017 | 2016 |

Edgar Filing: CARMAX INC - Form 10-Q

| | | |
|--|---------|---------|
| Stock units granted | 158,637 | 168,681 |
| Weighted average grant date fair value per share | \$73.58 | \$63.97 |
| Realized tax benefits (in millions) | \$7.0 | \$5.2 |

Page 21

Stock-Settled Performance Stock Unit Activity

| | | Weighted Average |
|-------------------------------------|-----------------------|--------------------------------|
| (Units in thousands) | Number of Units | Grant Date Fair Value |
| Outstanding as of February 28, 2017 | 149 | \$ 60.94 |
| Stock units granted | 74 | \$ 58.38 |
| Outstanding as of May 31, 2017 | 223 | \$ 60.10 |

Stock-Settled Performance Stock Unit Information

| | Three Months Ended May 31 | |
|--|------------------------------|---------|
| | 2017 | 2016 |
| Stock units granted | 73,648 | 83,032 |
| Weighted average grant date fair value per share | \$58.38 | \$51.63 |

Restricted Stock Awards Activity

| | | Weighted Average |
|-------------------------------------|-----------------------|--------------------------------|
| (Units in thousands) | Number of Units | Grant Date Fair Value |
| Outstanding as of February 28, 2017 | 50 | \$ 50.94 |
| Restricted stock vested | (1) | \$ 51.63 |
| Outstanding as of May 31, 2017 | 49 | \$ 50.93 |

Restricted Stock Awards Information

| | Three Months Ended May 31 |
|--|------------------------------------|
| | 2017 |
| Restricted stock granted | —19,998 |
| Weighted average grant date fair value per share | \$—51.63 |

12. Net Earnings Per Share

Basic net earnings per share is computed by dividing net earnings available for basic common shares by the weighted average number of shares of common stock outstanding. Diluted net earnings per share is computed by dividing net earnings available for diluted common shares by the sum of weighted average number of shares of common stock outstanding and dilutive potential common stock. Diluted net earnings per share is calculated using the “if-converted” treasury stock method.

Basic and Dilutive Net Earnings Per Share Reconciliations

| | Three Months Ended May 31 | |
|--|------------------------------|------------|
| (In thousands except per share data) | 2017 | 2016 |
| Net earnings | \$ 211,702 | \$ 175,360 |
| Weighted average common shares outstanding | 185,200 | 193,531 |
| Dilutive potential common shares: | | |
| Stock options | 1,209 | 1,248 |
| Stock-settled stock units and awards | 450 | 474 |
| Weighted average common shares and dilutive potential common shares | 186,859 | 195,253 |
| Basic net earnings per share | \$ 1.14 | \$ 0.91 |
| Diluted net earnings per share | \$ 1.13 | \$ 0.90 |

Certain options to purchase shares of common stock were outstanding and not included in the calculation of diluted net earnings per share because their inclusion would have been antidilutive. On a weighted average basis, for the three months ended May 31, 2017 and 2016, options to purchase 2,218,318 shares and 2,610,461 shares of common stock, respectively, were not included.

13. Accumulated Other Comprehensive Loss

Changes in Accumulated Other Comprehensive Loss By Component

| | Net Unrecognized Actuarial Losses | Net Unrecognized Hedge Losses | Total Accumulated Other Comprehensive Loss |
|--|--|--|--|
| (In thousands, net of income taxes) | | | |
| Balance as of February 28, 2017 | \$ (55,521) | \$ (1,034) | \$ (56,555) |
| Other comprehensive loss before reclassifications | — | (2,562) | (2,562) |
| Amounts reclassified from accumulated other comprehensive loss | 274 | 614 | 888 |

Edgar Filing: CARMAX INC - Form 10-Q

| | | | | | | |
|-----------------------------------|------------|--------|-----------|--------|------------|---|
| Other comprehensive income (loss) | 274 | (1,948 |) | (1,674 |) | |
| Balance as of May 31, 2017 | \$ (55,247 |) | \$ (2,982 |) | \$ (58,229 |) |

Page 23

Changes In and Reclassifications Out of Accumulated Other Comprehensive Loss

| (In thousands) | Three Months | |
|--|--------------|----------|
| | Ended May 31 | |
| | 2017 | 2016 |
| Retirement Benefit Plans (Note 9): | | |
| Actuarial loss amortization reclassifications recognized in net pension expense: | | |
| Cost of sales | \$ 185 | \$ 157 |
| CarMax Auto Finance income | 11 | 9 |
| Selling, general and administrative expenses | 258 | 221 |
| Total amortization reclassifications recognized in net pension expense | 454 | 387 |
| Tax expense | (180) | (138) |
| Amortization reclassifications recognized in net pension expense, net of tax | 274 | 249 |
| Net change in retirement benefit plan unrecognized actuarial losses, net of tax | 274 | 249 |
| Cash Flow Hedges (Note 5): | | |
| Effective portion of changes in fair value | (4,226) | 2,331 |
| Tax benefit (expense) | 1,664 | (916) |
| Effective portion of changes in fair value, net of tax | (2,562) | 1,415 |
| Reclassifications to CarMax Auto Finance income | 1,013 | 2,813 |
| Tax expense | (399) | (1,106) |
| Reclassification of hedge losses, net of tax | 614 | 1,707 |
| Net change in cash flow hedge unrecognized losses, net of tax | (1,948) | 3,122 |
| Total other comprehensive (loss) income, net of tax | \$(1,674) | \$3,371 |

Changes in the funded status of our retirement plans and the effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges are recognized in accumulated other comprehensive loss. The cumulative balances are net of deferred taxes of \$34.9 million as of May 31, 2017, and \$33.8 million as of February 28, 2017.

14. Supplemental Cash Flow Information

Supplemental disclosures of cash flow information:

| (In thousands) | Three Months | |
|---|--------------|------------|
| | Ended May 31 | |
| | 2017 | 2016 |
| Non-cash investing and financing activities: | | |
| Decrease in accrued capital expenditures | \$(1,077) | \$(10,634) |
| Increase in finance and capital lease obligations | \$— | \$20,392 |

15. Contingent Liabilities

Litigation. CarMax entities are defendants in three proceedings asserting wage and hour claims with respect to CarMax sales consultants in California. The asserted claims include failure to pay minimum wage, provide meal periods and rest breaks, pay statutory/contractual wages, reimburse for work-related expenses and provide accurate itemized wage statements; unfair competition; and Private Attorney General Act claims. On September 4, 2015, Craig Weiss et al., v. CarMax Auto Superstores California, LLC, and CarMax Auto Superstores West Coast, Inc., a putative class action, was filed in the Superior Court of California, County of Placer. The Weiss lawsuit seeks civil penalties, fines, cost of suit, and the recovery of attorneys' fees. On June 29, 2016, Ryan Gomez et al. v. CarMax Auto

Superstores California, LLC, and CarMax Auto Superstores West Coast, Inc., a putative class action, was filed in the Superior Court of the State of California, Los Angeles. The Gomez lawsuit seeks declaratory relief, unspecified damages, restitution, statutory penalties, interest, cost and attorneys' fees. On September 7, 2016, James Rowland v. CarMax Auto Superstores California, LLC, and CarMax Auto Superstores West Coast, Inc., a putative class action, was filed in the U.S. District Court, Eastern District of California, Sacramento Division. The Rowland lawsuit seeks unspecified damages, restitution, statutory penalties, interest, cost and attorneys' fees. We are unable to make a reasonable estimate of the amount or range of loss that could result from an unfavorable outcome in these matters.

On April 25, 2017, the Company met with representatives from multiple California municipality district attorney offices as part of an informal inquiry by those offices into the handling, storage and disposal of certain types of hazardous waste at our store locations in those municipalities. The meeting followed our ongoing dialogue with the Orange County, California District Attorney's office regarding these matters, which was disclosed in "Legal Proceedings" in Item 3 of the Annual Report on Form 10-K for the fiscal year ended February 28, 2017. We are unable to make a reasonable estimate of the amount or range of loss that could result from an unfavorable outcome in these matters.

We are involved in various other legal proceedings in the normal course of business. Based upon our evaluation of information currently available, we believe that the ultimate resolution of any such proceedings will not have a material adverse effect, either individually or in the aggregate, on our financial condition, results of operations or cash flows.

Other Matters. In accordance with the terms of real estate lease agreements, we generally agree to indemnify the lessor from certain liabilities arising as a result of the use of the leased premises, including environmental liabilities and repairs to leased property upon termination of the lease. Additionally, in accordance with the terms of agreements entered into for the sale of properties, we generally agree to indemnify the buyer from certain liabilities and costs arising subsequent to the date of the sale, including environmental liabilities and liabilities resulting from the breach of representations or warranties made in accordance with the agreements. We do not have any known material environmental commitments, contingencies or other indemnification issues arising from these arrangements. As part of our customer service strategy, we guarantee the used vehicles we retail with at least a 30-day limited warranty. A vehicle in need of repair within this period will be repaired free of charge. As a result, each vehicle sold has an implied liability associated with it. Accordingly, based on historical trends, we record a provision for estimated future repairs during the guarantee period for each vehicle sold. The liability for this guarantee was \$6.2 million as of May 31, 2017, and \$6.3 million as of February 28, 2017, and is included in accrued expenses and other current liabilities.

ITEM 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is provided as a supplement to, and should be read in conjunction with, our audited consolidated financial statements, the accompanying notes and the MD&A included in our Annual Report on Form 10-K for the fiscal year ended February 28, 2017 ("fiscal 2017"), as well as our consolidated financial statements and the accompanying notes included in Item 1 of this Form 10-Q. Note references are to the notes to consolidated financial statements included in Item 1. All references to net earnings per share are to diluted net earnings per share. Certain prior year amounts have been reclassified to conform to the current year's presentation. Amounts and percentages may not total due to rounding.

OVERVIEW

CarMax is the nation's largest retailer of used vehicles. We operate in two reportable segments: CarMax Sales Operations and CarMax Auto Finance ("CAF"). Our CarMax Sales Operations segment consists of all aspects of our auto merchandising and service operations, excluding financing provided by CAF. Our CAF segment consists solely of our own finance operation that provides financing to customers buying retail vehicles from CarMax.

CarMax Sales Operations

Our sales operations segment consists of retail sales of used vehicles and related products and services, such as wholesale vehicle sales; the sale of extended protection plan ("EPP") products, which include extended service plans ("ESPs") and guaranteed asset protection ("GAP"); and vehicle repair service. We offer low, no-haggle prices; a broad selection of CarMax Quality Certified used vehicles; value-added EPP products; and superior customer service. Our website and related mobile apps are tools for communicating the CarMax consumer offer in detail, sophisticated search engines for finding the right vehicle and sales channels for customers who prefer to conduct part of the shopping and sales process online.

Our customers finance the majority of the retail vehicles purchased from us, and availability of on-the-spot financing is a critical component of the sales process. We provide financing to qualified retail customers through CAF and our arrangements with industry-leading third-party finance providers. All of the finance offers, whether by CAF or our third-party providers, are backed by a 3-day payoff option.

As of May 31, 2017, we operated 176 used car stores in 87 U.S. television markets. As of that date, we also conducted wholesale auctions at 73 used car stores and we operated 2 new car franchises.

CarMax Auto Finance

In addition to third-party finance providers, we provide vehicle financing through CAF, which offers financing solely to customers buying retail vehicles from CarMax. CAF allows us to manage our reliance on third-party finance providers and to leverage knowledge of our business to provide qualifying customers a competitive financing option. As a result, we believe CAF enables us to capture additional profits, cash flows and sales. CAF income primarily reflects the interest and fee income generated by the auto loan receivables less the interest expense associated with the debt issued to fund these receivables, a provision for estimated loan losses and direct expenses. CAF income does not include any allocation of indirect costs. After the effect of 3-day payoffs and vehicle returns, CAF financed 41.9% of our retail used vehicle unit sales in the first three months of fiscal 2018. As of May 31, 2017, CAF serviced approximately 835,000 customer accounts in its \$10.98 billion portfolio of managed receivables.

Management regularly analyzes CAF's operating results by assessing the competitiveness of our consumer offer, profitability, the performance of the auto loan receivables, including trends in credit losses and delinquencies, and CAF direct expenses.

Revenues and Profitability -- Three Months Ended May 31, 2017

During the first quarter of fiscal 2018, net sales and operating revenues increased 10.1% and net earnings increased 20.7%. The 25.6% increase in earnings per share reflected the increase in net earnings and the effect of our ongoing share repurchase program.

Our primary source of revenue and net income is the retail sale of used vehicles. During the first quarter of fiscal 2018, we sold 195,273 used vehicles, representing 84.6% of our net sales and operating revenues and 66.6% of our gross profit. Compared to the prior year period, used vehicle revenues grew 12.1% and used vehicle gross profits improved 14.7%, primarily due to a 14.1% increase in total used unit sales, which included an 8.2% increase in comparable store used units.

Wholesale sales are also a significant contributor to our revenues and net income. During the first quarter of fiscal 2018, we sold 103,443 wholesale vehicles, representing 12.2% of our net sales and operating revenues and 16.1% of our gross profit. Compared to the prior year period, wholesale vehicle revenues fell 2.5%, primarily due to a decrease in wholesale vehicle average selling prices, and wholesale vehicle gross profits increased 1.7%, primarily due to a 1.7% increase in wholesale vehicle gross profit per unit.

During the first quarter of fiscal 2018, other sales and revenues, which include revenue earned on the sale of EPP products, net third-party finance fees, and service department and new vehicle sales, represented 3.2% of our net sales and operating revenues and 17.3% of our gross profit. Compared to the prior year period, other sales and revenues increased 12.3% and other gross profit rose 20.7%, primarily reflecting improvements in EPP revenues, which benefited from the increase in our used unit sales.

Income from our CAF segment totaled \$109.4 million in the first quarter of fiscal 2018, up 8.5% compared with the prior year period. The increase in CAF income was primarily due to an increase in average managed receivables, partially offset by a decrease in interest margin as a percentage of average managed receivables.

Selling, general and administrative (“SG&A”) expenses increased 6.1% to \$403.5 million, primarily reflecting the 11% increase in our store base since the beginning of the first quarter of fiscal 2017, as well as higher variable costs associated with our comparable store unit growth and spending related to strategic initiatives, partially offset by a decrease in share-based compensation expense.

Liquidity

Our primary ongoing sources of liquidity include funds provided by operations, proceeds from securitization transactions, and borrowings under our revolving credit facility or through other financing sources. During the first three months of fiscal 2018, net cash provided by operations totaled \$191.5 million. This amount, combined with \$260.9 million of net issuances of non-recourse notes payable, resulted in \$452.4 million of adjusted net cash provided by operating activities (a non-GAAP measure). This liquidity was primarily used to fund the increase in CAF auto loan receivables, the 3.0 million common shares repurchased under our share repurchase program, the reduction of our outstanding revolving credit borrowings and our store growth.

When considering cash provided by operating activities, management does not include increases in auto loan receivables that have been funded with non-recourse notes payable, which are separately reflected as cash provided by financing activities. For a reconciliation of adjusted net cash provided by operating activities to net cash provided by operating activities, the most directly comparable GAAP financial measure, see “Reconciliation of Adjusted Net Cash from Operating Activities” included in “FINANCIAL CONDITION – Liquidity and Capital Resources.”

Future Outlook

Over the long term, we believe the primary driver for earnings growth will be vehicle unit sales growth from both new stores and stores included in our comparable store base. We also believe that increased used vehicle unit sales will drive increased sales of wholesale vehicles and ancillary products and, over time, increased CAF income. To expand our vehicle unit sales at new and existing stores, we will need to continue delivering an unrivaled customer experience in stores and online, which will require investments in our information technology infrastructure and other strategic initiatives. We also will need to continue hiring and developing the associates necessary to drive our success, while managing the risks posed by an evolving competitive environment. In addition, to support our store growth plans, we will need to continue procuring suitable real estate at favorable terms. While in any individual period conditions may vary, over the long term we would expect to begin leveraging our SG&A expenses when comparable store used unit sales growth is in the mid-single digit range. In the near term, while we are investing more heavily in strategic initiatives, we believe the SG&A leverage point is likely at the higher end of this range.

We are continuing the national rollout of our retail concept, and as of May 31, 2017, we had used car stores located in 87 U.S. television markets, which covered approximately 72% of the U.S. population. During the first three months of fiscal 2018, we opened 3 stores, and during the remainder of the fiscal year, we plan to open 12 stores. In fiscal 2019, we plan to open between 13 and 16 stores. For a detailed list of stores we plan to open in the 12 months following May 31, 2017, see the table included in “PLANNED FUTURE ACTIVITIES.”

A significant portion of our used vehicle inventory is sourced from local, regional and online wholesale auto auctions. Wholesale vehicle prices are influenced by a variety of factors, including the supply of vehicles available at auction relative to dealer demand. Industry sources predict that there will be a continued influx in off-lease vehicles in coming years, which has and could continue to increase the volume of late-model vehicles available at auction relative to dealer demand. This has and could continue to reduce wholesale auction prices and our vehicle acquisition costs. It could also impact CAF recovery rates.

For additional information about risks and uncertainties facing our Company, see “Risk Factors,” included in Part I. Item 1A of the Annual Report on Form 10-K for the fiscal year ended February 28, 2017.

CRITICAL ACCOUNTING POLICIES

For information on critical accounting policies, see “Critical Accounting Policies” in MD&A included in Item 7 of the Annual Report on Form 10-K for the fiscal year ended February 28, 2017. These policies relate to financing and securitization transactions, revenue recognition and income taxes.

RESULTS OF OPERATIONS – CARMAX SALES OPERATIONS

NET SALES AND OPERATING REVENUES

| (In millions) | Three Months Ended May 31 | | |
|--|---------------------------|-----------|---------|
| | 2017 | 2016 | Change |
| Used vehicle sales | \$3,843.4 | \$3,429.0 | 12.1 % |
| Wholesale vehicle sales | 553.4 | 567.7 | (2.5)% |
| Other sales and revenues: | | | |
| Extended protection plan revenues | 91.9 | 76.2 | 20.5 % |
| Third-party finance fees, net | (11.4) | (11.9) | 4.2 % |
| Other | 65.1 | 65.4 | (0.4)% |
| Total other sales and revenues | 145.6 | 129.7 | 12.3 % |
| Total net sales and operating revenues | \$4,542.3 | \$4,126.4 | 10.1 % |

UNIT SALES

| | Three Months Ended May 31 | | |
|--------------------|------------------------------|---------|--------|
| | 2017 | 2016 | Change |
| Used vehicles | 195,273 | 171,076 | 14.1 % |
| Wholesale vehicles | 103,443 | 103,462 | — % |

AVERAGE SELLING PRICES

| | Three Months Ended May 31 | | |
|--------------------|------------------------------|----------|---------|
| | 2017 | 2016 | Change |
| Used vehicles | \$19,478 | \$19,858 | (1.9)% |
| Wholesale vehicles | \$5,113 | \$5,268 | (2.9)% |

COMPARABLE STORE USED VEHICLE SALES CHANGES

| | Three Months Ended May 31 | |
|-----------------------|------------------------------------|-------|
| | 2017 | 2016 |
| Used vehicle units | 8.2 % | 0.2 % |
| Used vehicle revenues | 6.1 % | 0.3 % |

Stores are added to the comparable store base beginning in their fourteenth full month of operation. We do not remove renovated stores from our comparable store base. Comparable store calculations include results for a set of stores that were included in our comparable store base in both the current and corresponding prior year periods.

VEHICLE SALES CHANGES

| | Three Months Ended May 31 | |
|----------------------------|------------------------------|---------|
| | 2017 | 2016 |
| Used vehicle units | 14.1 % | 4.0 % |
| Used vehicle revenues | 12.1 % | 4.1 % |
| Wholesale vehicle units | — % | 1.8 % |
| Wholesale vehicle revenues | (2.5) % | (1.5) % |

USED VEHICLE FINANCING PENETRATION BY CHANNEL (BEFORE THE IMPACT OF 3-DAY PAYOFFS)

| | Three Months Ended May 31 ⁽¹⁾ | |
|-----------------------|--|---------|
| | 2017 | 2016 |
| CAF ⁽²⁾ | 47.3 % | 49.1 % |
| Tier 2 ⁽³⁾ | 19.0 % | 18.5 % |
| Tier 3 ⁽⁴⁾ | 10.0 % | 11.2 % |
| Other ⁽⁵⁾ | 23.7 % | 21.2 % |
| Total | 100.0 % | 100.0 % |

(1) Calculated as used vehicle units financed for respective channel as a percentage of total used units sold.

(2) Includes CAF's Tier 3 loan originations, which represent less than 1% of total used units sold.

(3) Third-party finance providers who generally pay us a fee or to whom no fee is paid.

(4) Third-party finance providers to whom we pay a fee.

(5) Represents customers arranging their own financing and customers that do not require financing.

CHANGE IN USED CAR STORE BASE

| | Three Months Ended May 31 | |
|--------------------------------------|------------------------------------|------|
| | 2017 | 2016 |
| Used car stores, beginning of period | 173 | 158 |
| Store openings | 3 | 2 |
| Used car stores, end of period | 176 | 160 |

During the first three months of fiscal 2018, we opened three stores, including two stores in Seattle, WA, a new television market, and one store in Pensacola, FL.

Used Vehicle Sales. The 12.1% increase in used vehicle revenues in the first quarter of fiscal 2018 resulted from a 14.1% increase in used unit sales, partially offset by a 1.9% decline in average retail selling price. The increase in used unit sales included an 8.2% increase in comparable store used unit sales and sales from newer stores not yet included in the comparable store base. The comparable store used unit sales performance resulted from a continued improvement in conversion. We believe that strong execution in our stores as well as the impact of our digital initiatives contributed to our continued improvements in conversion. Website traffic grew 9%, which generated additional leads compared with the prior year's first quarter. Additionally, we believe our first quarter used unit sales also benefited somewhat from the delay of federal income tax refunds in February, which shifted some sales from the fourth quarter of last year into this year's first quarter. Our third party Tier 3 sales mix declined modestly as we began

to lap credit tightening by one of our Tier 3 finance providers implemented during the first quarter of last year. The decline in average retail selling price reflected the net effects of lower vehicle acquisition costs and shifts in the mix of our sales by both vehicle age and class.

Wholesale Vehicle Sales. Vehicles sold at our wholesale auctions are, on average, approximately 10 years old with more than 100,000 miles and are primarily comprised of vehicles purchased through our appraisal process that do not meet our retail standards. Our wholesale auction prices usually reflect the trends in the general wholesale market for the types of vehicles we sell, although they can also be affected by changes in vehicle mix or the average age, mileage or condition of the vehicles being sold.

The 2.5% decrease in wholesale vehicle revenues in the first quarter of fiscal 2018 was primarily due to a 2.9% decrease in wholesale vehicle average selling price, driven by changes in overall market conditions. Wholesale unit sales remained flat

compared with the prior year, as increased wholesale unit volume attributable to the growth in our store base was offset by a reduction in appraisal traffic. In particular, we continued to experience a reduced mix of 7- to 9-year old vehicles in our wholesale sales mix. We believe this reduction resulted, at least in part, from the reduced overall industry supply of these model year vehicles due to the decline in industry new vehicle sales during the recession.

Other Sales and Revenues. Other sales and revenues include revenue from the sale of ESPs and GAP (collectively reported in EPP revenues, net of a reserve for estimated contract cancellations), net third-party finance fees, and other revenues, which are predominantly comprised of service department and new vehicle sales. The fees we pay to the Tier 3 providers are reflected as an offset to finance fee revenues received from the Tier 2 providers. The mix of our retail vehicles financed by CAF, Tier 2 and Tier 3 providers, or customers that arrange their own financing, may vary from quarter to quarter depending on several factors, including the credit quality of applicants, changes in providers' credit decisioning and external market conditions. Changes in originations by one tier of credit providers may also affect the originations made by providers in other tiers.

Other sales and revenues increased 12.3% in the first quarter of fiscal 2018. EPP revenues increased 20.5% compared with the prior year's first quarter, largely reflecting the growth in our used unit sales, as well as modest favorable adjustments to cancellation reserves resulting from lower cancellation activity.

Seasonality. Historically, our business has been seasonal. Our stores typically experience their strongest traffic and sales in the spring and summer quarters. Sales are typically slowest in the fall quarter. We typically experience an increase in traffic and sales in February and March, coinciding with federal income tax refund season.

GROSS PROFIT

| (In millions) | Three Months Ended | | |
|--------------------------------|--------------------|---------|--------|
| | May 31 | | |
| | 2017 | 2016 | Change |
| Used vehicle gross profit | \$431.9 | \$376.6 | 14.7 % |
| Wholesale vehicle gross profit | 104.7 | 102.9 | 1.7 % |
| Other gross profit | 112.3 | 93.1 | 20.7 % |
| Total | \$648.9 | \$572.6 | 13.3 % |

GROSS PROFIT PER UNIT

| | Three Months Ended May | | | |
|--------------------------------|----------------------------|------------------|----------------------------|------------------|
| | 31 | | | |
| | 2017 | 2016 | | |
| | \$ per unit ⁽¹⁾ | % ⁽²⁾ | \$ per unit ⁽¹⁾ | % ⁽²⁾ |
| Used vehicle gross profit | \$2,212 | 11.2 | \$2,202 | 11.0 |
| Wholesale vehicle gross profit | \$1,012 | 18.9 | \$995 | 18.1 |
| Other gross profit | \$575 | 77.2 | \$544 | 71.8 |
| Total gross profit | \$3,323 | 14.3 | \$3,347 | 13.9 |

(1) Calculated as category gross profit divided by its respective units sold, except the other and total categories, which are divided by total used units sold.

(2) Calculated as a percentage of its respective sales or revenue.

Used Vehicle Gross Profit. We target a dollar range of gross profit per used unit sold. The gross profit dollar target for an individual vehicle is based on a variety of factors, including its probability of sale and its mileage relative to its age; however, it is not primarily based on the vehicle's selling price. Our ability to quickly adjust appraisal offers to be

consistent with the broader market trade-in trends and the pace of our inventory turns reduce our exposure to the inherent continual fluctuation in used vehicle values and contribute to our ability to manage gross profit dollars per unit.

We systematically mark down individual vehicle prices based on proprietary pricing algorithms in order to appropriately balance sales trends, inventory turns and gross profit achievement. Other factors that may influence gross profit include changes in our vehicle reconditioning costs, changes in the percentage of vehicles sourced directly from consumers through our appraisal process and changes in the wholesale pricing environment. Vehicles purchased directly from consumers typically generate more gross profit per unit compared with vehicles purchased at auction or through other channels.

Used vehicle gross profit rose 14.7% in the first quarter of fiscal 2018, driven by the 14.1% growth in total used unit sales, as our used vehicle gross profit per unit remained consistent with the corresponding prior year period. We believe we can manage to a targeted gross profit per unit dollar range, subject to future changes to our business or pricing strategy.

Wholesale Vehicle Gross Profit. Our wholesale gross profit per unit reflects the demand for older, higher mileage vehicles, which are the mainstay of our auctions, as well as strong dealer attendance and resulting high dealer-to-car ratios at our auctions. The frequency of our auctions, which are generally held weekly or bi-weekly, minimizes the depreciation risk on these vehicles. Our ability to adjust appraisal offers in response to the wholesale pricing environment is a key factor that influences wholesale gross profit.

Wholesale vehicle gross profit increased 1.7% in the first quarter of fiscal 2018, reflecting a \$17, or 1.7%, increase in wholesale vehicle gross profit per unit. We believe the delay in federal income tax refund season from the fourth quarter resulted in a corresponding delay in the normal seasonal increase in wholesale industry pricing, benefiting our first quarter wholesale gross profit per unit. This benefit more than offset the pressure on our wholesale vehicle gross profit per unit resulting from the reduced mix of 7- to 9-year old vehicles in our wholesale sales mix.

Other Gross Profit. Other gross profit includes profits related to EPP revenues, net third-party finance fees and other revenues, which are predominantly comprised of service department operations, including used vehicle reconditioning, and new vehicle sales. We have no cost of sales related to EPP revenues or net third-party finance fees, as these represent revenues paid to us by certain third-party providers. Third-party finance fees are reported net of the fees we pay to third-party Tier 3 finance providers. Accordingly, changes in the relative mix of the components of other gross profit can affect the composition and amount of other gross profit. Other gross profit rose 20.7% in the first quarter of fiscal 2018, primarily reflecting the improvements in EPP revenues discussed above.

Impact of Inflation. Historically, inflation has not had a significant impact on results. Profitability is primarily affected by our ability to achieve targeted unit sales and gross profit dollars per vehicle rather than by changes in average retail prices. However, changes in average vehicle selling prices impact CAF income, to the extent the average amount financed also changes.

SG&A Expenses

COMPONENTS OF SG&A EXPENSES

| | Three Months Ended | | | |
|---|--------------------|---------|---------|---|
| | May 31 | | | |
| (In millions except per unit data) | 2017 | 2016 | Change | |
| Compensation and benefits ⁽¹⁾ | \$222.5 | \$216.6 | 2.7 | % |
| Store occupancy costs | 79.7 | 71.7 | 11.1 | % |
| Advertising expense | 38.2 | 34.8 | 9.7 | % |
| Other overhead costs ⁽²⁾ | 63.1 | 57.1 | 10.6 | % |
| Total SG&A expenses | \$403.5 | \$380.2 | 6.1 | % |
| SG&A per used vehicle unit ⁽³⁾ | \$2,066 | \$2,223 | \$(157) | |

(1) Excludes compensation and benefits related to reconditioning and vehicle repair service, which are included in cost of sales. See Note 11 for details of share-based compensation expense by grant type.

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

(3) Calculated as total SG&A expenses divided by total used vehicle units.

SG&A expenses increased 6.1% in the first quarter of fiscal 2018. The increase primarily reflected the 11% growth in our store base since the beginning of last year's first quarter (representing the addition of 18 stores), higher variable costs associated with our comparable store unit growth and spending related to strategic initiatives. These increases were partially offset by an \$11.5 million decrease in share-based compensation expense, which reduced SG&A per unit by \$80. This decrease was largely related to cash-settled restricted stock units, which are awards provided broadly to non-executive associates in our organization. The expense associated with these units was influenced by the change in the company's stock price during the relevant quarters. In addition, we experienced some timing favorability related to planned spending on strategic initiatives and marketing.

Interest Expense. Interest expense includes the interest related to short- and long-term debt and finance and capital lease obligations. It does not include interest on the non-recourse notes payable, which is reflected within CAF income.

Interest expense rose to \$16.8 million in the first quarter of fiscal 2018, from \$11.1 million in the first quarter of fiscal 2017. The increase reflected the combination of higher outstanding debt levels in fiscal 2018, consistent with our capital structure strategy, as well as growth in our finance and capital lease obligations. See “FINANCIAL CONDITION – Liquidity and Capital Resources” for further discussion.

Income Taxes. The effective income tax rate was 37.4% in the first quarter of fiscal 2018 versus 38.0% in the first quarter of fiscal 2017. For the first quarter of fiscal 2018, our provision for income taxes and effective tax rate were reduced by \$2.4 million and 72 basis points, respectively, due to the adoption of Financial Accounting Standards Board's (“FASB”) Accounting Standards Update (“ASU”) 2016-09 on share-based compensation. The standard requires the income tax effects of our share-based awards to be recognized in the provision for income taxes when the awards vest or are settled. Previously, these tax effects were recognized within shareholders’ equity as capital in excess of par value. We have adopted this provision of the standard on a prospective basis.

RESULTS OF OPERATIONS – CARMAX AUTO FINANCE

CAF income primarily reflects the interest and fee income generated by CAF’s portfolio of auto loan receivables less the interest expense associated with the debt issued to fund these receivables, a provision for estimated loan losses and direct CAF expenses. CAF income does not include any allocation of indirect costs. Although CAF benefits from certain indirect overhead expenditures, we have not allocated indirect costs to CAF to avoid making subjective allocation decisions. Examples of indirect costs not allocated to CAF include retail store expenses and corporate expenses.

CAF’s managed portfolio is composed primarily of loans originated over the past several years. Trends in receivable growth and interest margins primarily reflect the cumulative effect of changes in the business over a multi-year period. We strive to originate loans with an underlying risk profile that we believe will, in the aggregate and excluding CAF's Tier 3 originations, result in cumulative net losses in the 2% to 2.5% range over the life of the loans. Actual loss performance of the loans may fall outside of this range based on various factors, including intentional changes in the risk profile of originations, economic conditions and wholesale recovery rates. Current period originations reflect current trends in both our retail sales and the CAF business, including the volume of loans originated, current interest rates charged to consumers, loan terms and average credit scores. Because we recognize CAF income over the life of the underlying auto loan, loans originated in a given fiscal period generally do not have a significant effect on that period’s financial results.

See Note 3 for additional information on CAF income and Note 4 for information on auto loan receivables, including credit quality.

SELECTED CAF FINANCIAL INFORMATION

| (In millions) | Three Months Ended May 31 | | | |
|----------------------------|---------------------------|------------------|-----------|------------------|
| | 2017 | % ⁽¹⁾ | 2016 | % ⁽¹⁾ |
| Interest margin: | | | | |
| Interest and fee income | \$206.7 | 7.6 | \$184.1 | 7.6 |
| Interest expense | (49.0) | (1.8) | (39.4) | (1.6) |
| Total interest margin | \$157.7 | 5.8 | \$144.7 | 5.9 |
| Provision for loan losses | \$(28.6) | (1.1) | \$(26.6) | (1.1) |
| CarMax Auto Finance income | \$109.4 | 4.0 | \$100.8 | 4.1 |

⁽¹⁾ Annualized percentage of total average managed receivables.

CAF ORIGINATION INFORMATION (AFTER THE IMPACT OF 3-DAY PAYOFFS)

| | Three Months Ended | | |
|---|--------------------|-----------|---|
| | May 31 | | |
| | 2017 | 2016 | |
| Net loans originated (in millions) | \$1,546.1 | \$1,443.4 | |
| Vehicle units financed | 81,787 | 75,084 | |
| Net penetration rate ⁽¹⁾ | 41.9 | % 43.9 | % |
| Weighted average contract rate | 7.8 | % 7.5 | % |
| Weighted average credit score ⁽²⁾ | 705 | 703 | |
| Weighted average loan-to-value (LTV) ⁽³⁾ | 94.7 | % 94.4 | % |
| Weighted average term (in months) | 65.9 | 66.0 | |

(1) Vehicle units financed as a percentage of total used units sold.

The credit scores represent FICO® scores and reflect only receivables with obligors that have a FICO® score at the time of application. The FICO® score with respect to any receivable with co-obligors is calculated as the average of each obligor's FICO® score at the time of application. FICO® scores are not a significant factor in our primary scoring model, which relies on information from credit bureaus and other application information as discussed in Note 4. FICO® is a federally registered servicemark of Fair Isaac Corporation.

(2) LTV represents the ratio of the amount financed to the total collateral value, which is measured as the vehicle selling price plus applicable taxes, title and fees.

LOAN PERFORMANCE INFORMATION

| (In millions) | As of and for the Three Months Ended | | |
|---|--------------------------------------|-----------|---|
| | May 31 | | |
| | 2017 | 2016 | |
| Total ending managed receivables | \$10,983.3 | \$9,914.3 | |
| Total average managed receivables | \$10,829.5 | \$9,745.0 | |
| Allowance for loan losses ⁽¹⁾ | \$129.8 | \$104.0 | |
| Allowance for loan losses as a percentage of ending managed receivables | 1.18 | % 1.05 | % |
| Net credit losses on managed receivables | \$22.4 | \$17.5 | |
| Annualized net credit losses as a percentage of total average managed receivables | 0.83 | % 0.72 | % |
| Past due accounts as a percentage of ending managed receivables | 3.08 | % 2.84 | % |
| Average recovery rate ⁽²⁾ | 47.8 | % 50.0 | % |

(1) The allowance for loan losses represents an estimate of the amount of net losses inherent in our portfolio of managed receivables as of the applicable reporting date and anticipated to occur during the following 12 months.

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

CAF income increased 8.5% in the first quarter of fiscal 2018. The increase was due to an increase in average managed receivables, partially offset by a lower total interest margin percentage. Average managed receivables grew 11.1% in the first quarter of fiscal 2018 driven by the rise in CAF loan originations in recent years. The growth in net loan originations in fiscal 2018 resulted from our used vehicle sales growth, partially offset by a decrease in CAF's penetration rate and a decline in average amount financed.

The total interest margin, which reflects the spread between interest and fees charged to consumers and our funding costs, declined as a percentage of average managed receivables to 5.8% in the first quarter of fiscal 2018 from 5.9% in the corresponding prior year period. This was the result of gradual compression of the spread between rates charged to consumers and our funding costs in recent years. Changes in the interest margin on new originations affect CAF income over time. Continued increases in interest rates, which affect CAF's funding costs, or other competitive pressures on consumer rates, could result in further compression in the interest margin on new originations.

The provision for loan losses rose to \$28.6 million in the first quarter of fiscal 2018 from \$26.6 million in the prior year period, primarily reflecting the growth in managed receivables. Our net loss experience in the first quarter of fiscal 2018 was generally in line with our loss expectations as of the end of fiscal 2017. As a result, the allowance for loan losses as a percentage of ending managed receivables was 1.18% as of May 31, 2017, similar to the 1.16% allowance ratio as of February 28, 2017. Compared

with May 31, 2016, the increase in the allowance ratio reflected higher loss experience over the course of last year. Changes in the allowance for loan losses as a percentage of ending managed receivables reflect the effect of the change in loss and delinquency experience on our outlook for net losses expected to occur over the next 12 months. Tier 3 Loan Originations. CAF also originates a small portion of auto loans to customers who typically would be financed by our Tier 3 finance providers, in order to better understand the performance of these loans, mitigate risk and add incremental profits. CAF currently targets originating approximately 5% of the total Tier 3 loan volume; however, this rate may vary over time based on market conditions. A total of \$134.2 million and \$123.3 million in CAF Tier 3 receivables were outstanding as of May 31, 2017 and February 28, 2017, respectively. These loans have higher loss and delinquency rates than the remainder of the CAF portfolio, as well as higher contract rates. As of May 31, 2017 and February 28, 2017, approximately 10% of the total allowance for loan losses related to the outstanding CAF Tier 3 loan balances.

PLANNED FUTURE ACTIVITIES

We currently plan to open 15 stores in fiscal 2018 and between 13 and 16 stores in fiscal 2019. We currently estimate capital expenditures will total approximately \$325 million in fiscal 2018 versus \$412 million in fiscal 2017. The decrease in planned capital spending primarily reflects reduced spending on construction and land acquisitions resulting from changes in the mix of markets in which stores are being built.

We currently plan to open the following stores within 12 months from May 31, 2017. During this period, we will be entering five new television markets and expanding our presence in ten existing television markets. Of the 16 stores we plan to open during the 12 months ending May 31, 2018, 8 will be in Metropolitan Statistical Areas having populations of 600,000 or less, which we define as small markets.

PLANNED STORE OPENINGS – NEXT 12 MONTHS

| Location | Television Market | Metropolitan Statistical Area | Planned Opening Date |
|---------------------------------------|---|-------------------------------|----------------------|
| Waterbury, Connecticut ⁽¹⁾ | Hartford/New Haven | New Haven | Q2 Fiscal 2018 |
| San Jose, California ⁽¹⁾ | San Francisco/Oakland/San Jose | San Jose | Q2 Fiscal 2018 |
| Salisbury, Maryland | Salisbury ⁽²⁾ | Salisbury | Q2 Fiscal 2018 |
| Langhorne, Pennsylvania | Philadelphia | Philadelphia | Q3 Fiscal 2018 |
| Tyler, Texas | Tyler/Longview ⁽²⁾ | Tyler | Q3 Fiscal 2018 |
| Las Vegas, Nevada | Las Vegas | Las Vegas | Q3 Fiscal 2018 |
| Colma, California | San Francisco/Oakland/San Jose | San Francisco/Oakland | Q3 Fiscal 2018 |
| Renton, Washington | Seattle/Tacoma | Seattle/Tacoma | Q3 Fiscal 2018 |
| Myrtle Beach, South Carolina | Myrtle Beach/Florence ⁽²⁾ | Myrtle Beach | Q4 Fiscal 2018 |
| South Portland, Maine | Portland/Auburn ⁽²⁾ | Portland | Q4 Fiscal 2018 |
| Manchester, New Hampshire | Boston | Manchester | Q4 Fiscal 2018 |
| Golden, Colorado | Denver | Denver/Aurora | Q4 Fiscal 2018 |
| Santa Fe, New Mexico | Albuquerque/Santa Fe | Santa Fe | Q1 Fiscal 2019 |
| Winterville, North Carolina | Greenville/New Bern/Washington ⁽²⁾ | Greenville | Q1 Fiscal 2019 |
| McKinney, Texas | Dallas/Ft. Worth | Dallas/Ft. Worth | Q1 Fiscal 2019 |
| Jensen Beach, Florida | Miami/Ft. Lauderdale/W. Palm Beach | Port St. Lucie | Q1 Fiscal 2019 |

⁽¹⁾ Store opened in June 2017.

⁽²⁾ Represents new television market as of planned store opening date.

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

FINANCIAL CONDITION

Liquidity and Capital Resources.

Our primary ongoing cash requirements are to fund our existing operations, store expansion and improvement and CAF. Since fiscal 2013, we have also elected to use cash for our share repurchase program. Our primary ongoing sources of liquidity include funds provided by operations, proceeds from securitization transactions or other funding arrangements, and borrowings under our revolving credit facility or through other financing sources.

We currently target an adjusted debt-to-total capital ratio in a range of 35% to 45%. In calculating this ratio, we utilize total debt, excluding non-recourse notes payable, a multiple of 8 times rent expense and total shareholders' equity. We expect to use our revolving credit facility and other financing sources, together with stock repurchases, to achieve and maintain this targeted ratio; however, in any period, we may be outside this range due to seasonal, market, strategic or other factors.

Operating Activities. During the first three months of fiscal 2018, net cash provided by operating activities totaled \$191.5 million, compared with \$87.6 million in the prior year period. The net cash provided by operating activities included increases in auto loan receivables of \$325.3 million in the current year period and \$343.1 million in the prior year period. The majority of the increases in auto loan receivables are accompanied by increases in non-recourse notes payable, which are separately reflected as cash from financing activities.

As of May 31, 2017, total inventory was \$2.15 billion, representing a decrease of \$112.3 million, or 5.0%, compared with the balance as of the start of the fiscal year. The decrease reflected a return to more normal inventory levels after having built inventories in the latter portion of fiscal 2017 to better position ourselves for seasonal sales opportunities. Additionally, inventory levels were more elevated than normal at the end of fiscal 2017 as a result of delays in federal income tax refunds that we believe impacted the timing of anticipated sales in February.

When considering cash provided by operating activities, management uses an adjusted measure of net cash from operating activities that offsets the changes in auto loan receivables with the corresponding changes in non-recourse notes payable. This is achieved by adding back the cash provided from the net issuances of non-recourse notes payable, which represents the increase in auto loan receivables that were funded through the issuance of non-recourse notes payable during the period. The resulting financial measure, adjusted net cash from operating activities, is a non-GAAP financial measure. We believe adjusted net cash from operating activities is a meaningful metric for investors because it provides better visibility into the cash generated from operations. Including the increases in non-recourse notes payable, net cash provided by operating activities would have been as follows:

RECONCILIATION OF ADJUSTED NET CASH FROM OPERATING ACTIVITIES

| (In millions) | Three Months | |
|---|--------------|---------|
| | Ended May 31 | |
| | 2017 | 2016 |
| Net cash provided by operating activities ⁽¹⁾ | \$191.5 | \$87.6 |
| Add: Net issuances of non-recourse notes payable ⁽²⁾ | 260.9 | 306.6 |
| Adjusted net cash provided by operating activities | \$452.4 | \$394.2 |

In connection with our adoption of FASB ASU 2016-09 during the current fiscal year, cash flows related to excess (1) tax benefits from share-based payment arrangements are now classified as operating activities, rather than financing activities, in the consolidated statements of cash flows. Prior period amounts have been reclassified to conform to the current year's presentation.

(2) Calculated using the gross issuances less payments on non-recourse notes payable as disclosed on the consolidated statements of cash flows.

Adjusted net cash provided by operating activities for the first three months of the current fiscal year increased compared to the prior year period primarily due to the impact of the change in inventory during the current fiscal year as well as the increase in net income.

Investing Activities. During the first three months of the fiscal year, net cash used in investing activities totaled \$90.4 million in fiscal 2018 compared with \$123.3 million in fiscal 2017. Capital expenditures were \$79.4 million in the current year period versus \$97.5 million in the prior year period. Capital expenditures primarily include store construction costs, real estate acquisitions for planned future store openings, and store remodeling costs. We maintain a multi-year pipeline of sites to support our store growth, so portions of capital spending in one year may relate to stores that we open in subsequent fiscal years. The decrease in capital expenditures in the current year period largely reflected reduced spending on construction and land acquisitions resulting from changes in the mix of markets in which stores are being built.

As of May 31, 2017, 102 of our 176 used car stores were located on owned sites and 74 were located on leased sites, including 18 land-only leases and 56 land and building leases.

Financing Activities. During the first three months of the fiscal year, net cash used in financing activities totaled \$79.5 million in fiscal 2018 compared with \$50.8 million of net cash provided by financing activities in fiscal 2017. Included in these amounts were net increases in total non-recourse notes payable of \$260.9 million and \$306.6 million, respectively, which were used to provide the financing for the majority of the increases of \$325.3 million and \$343.1 million, respectively, in auto loan receivables (see “Operating Activities”).

During the first three months of fiscal 2018, we reduced net borrowings on our revolving credit facility with net repayments of \$155.0 million compared with \$115.0 million in the first three months of fiscal 2017. Net cash used in or provided by financing activities was also impacted by stock repurchases of \$187.4 million in the first three months of fiscal 2018 compared with \$138.0 million in the first three months of fiscal 2017.

TOTAL DEBT AND CASH AND CASH EQUIVALENTS

| | As of May 31 2017 | As of February 28 2017 |
|--|-------------------------|------------------------------|
| (In thousands) | | |
| Borrowings under revolving credit facility | \$693 | \$155,062 |
| Other long-term debt | 800,000 | 800,000 |
| Finance and capital lease obligations | 494,166 | 496,136 |
| Non-recourse notes payable | 11,003,290 | 10,742,425 |
| Total debt ⁽¹⁾ | \$12,298,149 | \$12,193,623 |
| Cash and cash equivalents | \$60,080 | \$38,416 |

⁽¹⁾ Total debt excludes unamortized debt issuance costs. See Note 10 for additional information.

We have a \$1.20 billion unsecured revolving credit facility, which expires in August 2020. Borrowings under this credit facility are available for working capital and general corporate purposes, and the unused portion is fully available to us. We also have a \$300 million variable-rate term loan, which is due in August 2020. In addition, we have \$500 million of fixed-rate senior unsecured notes, which are due in 2023, 2026 and 2028. The credit facility, term loan and senior note agreements contain representations and warranties, conditions and covenants. If these requirements were not met, all amounts outstanding or otherwise owed could become due and payable immediately and other limitations could be placed on our ability to use any available borrowing capacity.

Finance and capital lease obligations relate primarily to stores subject to sale-leaseback transactions that did not qualify for sale accounting and, therefore, are accounted for as financings. Payments on the leases are recognized as interest expense and a reduction of the obligations. In the event the leases are modified or extended beyond their original lease term, the related obligation is increased based on the present value of the revised future minimum lease payments, with a corresponding increase to the assets subject to these transactions. Upon modification, the amortization of the obligation is reset, resulting in more of the lease payments being applied to interest expense in the initial years following the modification.

See Note 10 for additional information on our revolving credit facility, term loan, senior notes and finance and capital lease obligations.

CAF auto loan receivables are primarily funded through our warehouse facilities and term securitization transactions. Our funding vehicles are structured to legally isolate the auto loan receivables, and we would not expect to be able to access the assets of our funding vehicles, even in insolvency, receivership or conservatorship

proceedings. Similarly, the investors in the non-recourse notes payable have no recourse to our assets beyond the related receivables, the amounts on deposit in reserve accounts and the restricted cash from collections on auto loan receivables. We do, however, continue to have the rights associated with the interest we retain in these funding vehicles. Loans originated in the CAF Tier 3 loan origination program are primarily being funded through a \$100 million warehouse facility, as well as the use of existing working capital.

The timing of principal payments on the non-recourse notes payable is based on the timing of principal collections and defaults on the related auto loan receivables. The current portion of non-recourse notes payable represents principal payments that are due to be distributed in the following period.

As of May 31, 2017, \$8.98 billion of non-recourse notes payable was outstanding related to term securitizations. These notes payable have scheduled maturities through October 2023, but they may mature earlier, depending on the repayment rate of the underlying auto loan receivables. During the first three months of fiscal 2018, we completed one term securitization, funding a total of \$1.00 billion of auto loan receivables.

As of May 31, 2017, \$2.02 billion of non-recourse notes payable was outstanding related to our warehouse facilities. We have periodically increased our warehouse facility limit over time, as our store base, sales and CAF loan originations have grown. As of May 31, 2017, the combined warehouse facility limit was \$2.80 billion, and the unused warehouse capacity totaled \$778.0 million. Of the combined warehouse facility limit, \$1.30 billion will expire in August 2017 and \$1.50 billion will expire in February 2018. See Notes 2 and 10 for additional information on the warehouse facilities.

The agreements related to the warehouse facilities include various representations and warranties, covenants and performance triggers. If these requirements are not met, we could be unable to continue to fund receivables through the warehouse facilities. In addition, warehouse facility investors could charge us a higher rate of interest and could have us replaced as servicer. Further, we could be required to deposit collections on the related receivables with the warehouse facility agents on a daily basis and deliver executed lockbox agreements to the warehouse facility agents.

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

The timing and amount of stock repurchases are determined based on share price, market conditions, legal requirements and other factors. Shares repurchased are deemed authorized but unissued shares of common stock. As of May 31, 2017, the board had authorized a total of \$4.55 billion of repurchases. At that date, \$1.41 billion was available for repurchase, with no expiration date, under the board's outstanding authorization. See Note 11 for more information on share repurchase activity.

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

FORWARD-LOOKING STATEMENTS

We caution readers that the statements contained in this report about our future business plans, operations, capital structure, opportunities, or prospects, including without limitation any statements or factors regarding expected sales, margins, expenditures, CAF income, stock repurchases, indebtedness, earnings, or market conditions are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. You can identify these forward-looking statements by the use of words such as “anticipate,” “believe,” “could,” “estimate,” “expect,” “intend,” “may,” “outlook,” “plan,” “predict,” “should,” “will” and other similar expressions, whether negative or affirmative. Such forward-looking statements are based upon management’s current knowledge and assumptions about future events and involve risks and uncertainties that could cause actual results to differ materially from anticipated results. We disclaim any intent or obligation to update these statements. Among the factors that could cause actual results and outcomes to differ materially from those contained in the forward-looking statements are the following:

- Changes in the competitive landscape and/or our failure to successfully adjust to such changes.
- Events that damage our reputation or harm the perception of the quality of our brand.
- Changes in general or regional U.S. economic conditions.
- Changes in the availability or cost of capital and working capital financing, including changes related to the asset-backed securitization market.
- Our inability to recruit, develop and retain associates and maintain positive associate relations.
- The loss of key associates from our store, regional or corporate management teams or a significant increase in labor costs.
- Security breaches or other events that result in the misappropriation, loss or other unauthorized disclosure of confidential customer, associate or corporate information.
- Significant changes in prices of new and used vehicles.
- Changes in economic conditions or other factors that result in greater credit losses for CAF’s portfolio of auto loan receivables than anticipated.
- A reduction in the availability of or access to sources of inventory or a failure to expeditiously liquidate inventory.
- Changes in consumer credit availability provided by our third-party financing providers.
- Changes in the availability of extended protection plan products from third-party providers.
- Factors related to the regulatory and legislative environment in which we operate.
- Factors related to geographic and sales growth, including the inability to effectively manage our growth.
 - The failure of or inability to sufficiently enhance key information systems.
- The effect of various litigation matters.
- Adverse conditions affecting one or more automotive manufacturers, and manufacturer recalls.
- The inaccuracy of estimates and assumptions used in the preparation of our financial statements, or the effect of new accounting requirements or changes to U.S. generally accepted accounting principles.
- The performance of third-party vendors we rely on for key components of our business.
- Factors related to seasonal fluctuations in our business.
- The occurrence of severe weather events.
- Factors related to the geographic concentration of our stores.

For more details on factors that could affect expectations, see Part II, Item 1A, “Risk Factors” on Page 40 of this report, our Annual Report on Form 10-K for the fiscal year ended February 28, 2017, and our quarterly or current reports as filed with or furnished to the U.S. Securities and Exchange Commission (“SEC”). Our filings are publicly available on our investor information home page at investors.carmax.com. Requests for information may also be made to our Investor Relations Department by email to investor_relations@carmax.com or by calling 1-804-747-0422, ext. 4391.

We undertake no obligation to update or revise any forward-looking statements after the date they are made, whether as a result of new information, future events or otherwise.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no material changes to our market risk since February 28, 2017. For information on our exposure to market risk, refer to Part II, Item 7A, “Quantitative and Qualitative Disclosures about Market Risk,” contained in our Annual Report on Form 10-K for the year ended February 28, 2017.

Item 4. Controls and Procedures

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

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

Internal Control over Financial Reporting. There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during the quarter ended May 31, 2017, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

For a discussion of legal proceedings, see Note 15 to the consolidated financial statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q.

Item 1A. Risk Factors

In connection with information set forth in this Form 10-Q, the factors discussed under “Risk Factors” in our Form 10-K for fiscal year ended February 28, 2017, should be considered. These risks could materially and adversely affect our business, financial condition, and results of operations. There have been no material changes to the factors discussed in our Form 10 K.

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

On October 22, 2014, we announced that the board had authorized the repurchase of up to \$2 billion of our common stock, expiring on December 31, 2016. On June 28, 2016, we announced that the board had further authorized the repurchase of up to an additional \$750 million of our common stock. At the same time, the board removed the expiration date of the outstanding repurchase authorizations. Purchases may be made in open market or privately negotiated transactions at management’s discretion and the timing and amount of repurchases are determined based on share price, market conditions, legal requirements and other factors. Shares repurchased are deemed authorized but unissued shares of common stock.

The following table provides information relating to the company’s repurchase of common stock for the first quarter of fiscal 2018. The table does not include transactions related to employee equity awards or the exercise of employee stock options.

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Program | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Program |
|--------------------|---|--|---|--|
| March 1 - 31, 2017 | 857,597 | \$ 62.15 | 857,597 | \$1,537,064,521 |
| April 1 - 30, 2017 | 1,052,200 | \$ 57.57 | 1,052,200 | \$1,476,490,980 |
| May 1 - 31, 2017 | 1,124,906 | \$ 60.64 | 1,124,906 | \$1,408,274,260 |
| Total | 3,034,703 | | 3,034,703 | |

Item 6. Exhibits

10.1 CarMax, Inc. Annual Performance-Based Bonus Plan, as amended and restated, filed as Exhibit 10.1 to CarMax's Current Report on Form 8-K, filed June 29, 2017 (File No. 1-31420), is incorporated by reference.

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

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

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

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

101.INS XBRL Instance Document

101.SCHXBRL Taxonomy Extension Schema Document

101.CALXBRL Taxonomy Extension Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document

101.LABXBRL Taxonomy Extension Label Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

SIGNATURES

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

CARMAX, INC.

By: /s/ William D. Nash
William D. Nash
President and
Chief Executive Officer

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

July 7, 2017

Page 42

EXHIBIT INDEX

- 10.1 CarMax, Inc. Annual Performance-Based Bonus Plan, as amended and restated, filed as Exhibit 10.1 to CarMax's Current Report on Form 8-K, filed June 29, 2017 (File No. 1-31420), is incorporated by reference.
- 31.1 Certification of the Chief Executive Officer Pursuant to Rule 13a-14(a), filed herewith.
- 31.2 Certification of the Chief Financial Officer Pursuant to Rule 13a-14(a), filed herewith.
- 32.1 Certification of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, filed herewith.
- 32.2 Certification of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, filed herewith.
- 101.INS XBRL Instance Document
- 101.SCHXBRL Taxonomy Extension Schema Document
- 101.CALXBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LABXBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document