SONIC AUTOMOTIVE INC
Form 10-Q
October 26, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2017

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission File Number: 1-13395

SONIC AUTOMOTIVE, INC.

(Exact name of registrant as specified in its charter)

Delaware	56-2010790
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

4401 Colwick Road

Charlotte, North Carolina	28211
(Address of principal executive offices)	(Zip Code)

(704) 566-2400

(Registrant's telephone number, including area code)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a 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		Accelerated filer
Non-accelerated filer	(Do not check if a smaller reporting company)	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 Exchange Act). Yes No

As of October 23, 2017, there were 31,166,205 shares of Class A common stock and 12,029,375 shares of Class B common stock outstanding.

Uncertainty of Forward-Looking Statements and Information

This Quarterly Report on Form 10-Q contains, and written or oral statements made from time to time by us or by our authorized officers may contain, “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements address our future objectives, plans and goals, as well as our intent, beliefs and current expectations regarding future operating performance, results and events, and can generally be identified by words such as “may,” “will,” “should,” “believe,” “expect,” “estimate,” “anticipate,” “intend,” “plan,” “foresee
similar words or phrases.

These forward-looking statements are based on our current estimates and assumptions and involve various risks and uncertainties. As a result, you are cautioned that these forward-looking statements are not guarantees of future performance, and that actual results could differ materially from those projected in these forward-looking statements. Factors which may cause actual results to differ materially from our projections include those risks described in “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2016 and elsewhere in this report, as well as:

- the number of new and used vehicles sold in the United States as compared to our expectations and the expectations of the market;
- our ability to generate sufficient cash flows or obtain additional financing to fund our EchoPark expansion, our One Sonic-One Experience initiative, capital expenditures, our share repurchase program, dividends on our common stock, acquisitions and general operating activities;
- our business and growth strategies, including, but not limited to, our EchoPark initiative and our One Sonic-One Experience initiative;
- the reputation and financial condition of vehicle manufacturers whose brands we represent, the financial incentives vehicle manufacturers offer and their ability to design, manufacture, deliver and market their vehicles successfully;
- our relationships with manufacturers, which may affect our ability to obtain desirable new vehicle models in inventory or complete additional acquisitions;
- the adverse resolution of one or more significant legal proceedings against us or our franchised dealerships or pre-owned stores;
- changes in laws and regulations governing the operation of automobile franchises, accounting standards, taxation requirements and environmental laws;
- general economic conditions in the markets in which we operate, including fluctuations in interest rates, employment levels, the level of consumer spending and consumer credit availability;
- high competition in the automotive retailing industry, which not only creates pricing pressures on the products and services we offer, but also on businesses we may seek to acquire;
- our ability to successfully integrate potential future acquisitions; and
- the rate and timing of overall economic recovery or decline.

These forward-looking statements speak only as of the date of this report or when made, and we undertake no obligation to revise or update these statements to reflect subsequent events or circumstances, except as required under the federal securities laws and the rules and regulations of the Securities and Exchange Commission.

SONIC AUTOMOTIVE, INC.

FORM 10-Q

FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2017

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements.

SONIC AUTOMOTIVE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
	(Dollars and shares in thousands, except per share amounts)			
Revenues:				
New vehicles	$ 1,362,301	$ 1,375,144	$ 3,809,302	$ 3,826,178
Used vehicles	659,724	660,974	1,936,088	1,881,514
Wholesale vehicles	43,098	70,522	130,174	153,141
Total vehicles	2,065,123	2,106,640	5,875,564	5,860,833
Parts, service and collision repair	347,717	361,709	1,060,873	1,059,093
Finance, insurance and other, net	92,861	89,579	262,832	254,940
Total revenues	2,505,701	2,557,928	7,199,269	7,174,866
Cost of Sales:				
New vehicles	(1,296,063)	(1,312,756)	(3,622,264)	(3,639,500)
Used vehicles	(620,579)	(621,352)	(1,816,076)	(1,764,393)
Wholesale vehicles	(46,390)	(73,029)	(136,555)	(158,566)
Total vehicles	(1,963,032)	(2,007,137)	(5,574,895)	(5,562,459)
Parts, service and collision repair	(180,047)	(191,706)	(550,788)	(554,867)
Total cost of sales	(2,143,079)	(2,198,843)	(6,125,683)	(6,117,326)
Gross profit	362,622	359,085	1,073,586	1,057,540
Selling, general and administrative expenses	(283,974)	(282,141)	(870,139)	(843,721)
Impairment charges	(200)	(6,089)	(3,315)	(6,240)
Depreciation and amortization	(22,686)	(19,928)	(65,751)	(57,302)
Operating income (loss)	55,762	50,927	134,381	150,277
Other income (expense):				
Interest expense, floor plan	(8,882)	(6,672)	(26,413)	(19,797)
Interest expense, other, net	(13,028)	(13,016)	(39,200)	(37,560)
Other income (expense), net	4	11	(14,490)	120
Total other income (expense)	(21,906)	(19,677)	(80,103)	(57,237)
Income (loss) from continuing operations before taxes	33,856	31,250	54,278	93,040
Provision for income taxes for continuing operations - benefit (expense)	(14,126)	(12,281)	(22,254)	(36,565)
Income (loss) from continuing operations	19,730	18,969	32,024	56,475
Discontinued operations:				
Income (loss) from discontinued operations before taxes	(481)	(1,413)	(1,650)	(1,513)

Provision for income taxes for discontinued operations - benefit (expense)	191	555	657	595
Income (loss) from discontinued operations	(290)	(858)	(993)	(918)
Net income (loss)	$19,440	$18,111	$31,031	$ 55,557
Basic earnings (loss) per common share:				
Earnings (loss) per share from continuing operations	$0.45	$0.42	$0.72	$ 1.23
Earnings (loss) per share from discontinued operations	-	(0.02)	(0.02)	(0.02)
Earnings (loss) per common share	$0.45	$0.40	$0.70	$ 1.21
Weighted average common shares outstanding	43,496	45,118	44,281	45,930
Diluted earnings (loss) per common share:				
Earnings (loss) per share from continuing operations	$0.45	$0.42	$0.72	$ 1.22
Earnings (loss) per share from discontinued operations	(0.01)	(0.02)	(0.02)	(0.02)
Earnings (loss) per common share	$0.44	$0.40	$0.70	$ 1.20
Weighted average common shares outstanding	43,811	45,354	44,585	46,130
Dividends declared per common share	$0.05	$0.05	$0.15	$ 0.15

See notes to condensed consolidated financial statements.

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SONIC AUTOMOTIVE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended September 30, 2017	Three Months Ended September 30, 2016	Nine Months Ended September 30, 2017	Nine Months Ended September 30, 2016
	(In thousands)			
Net income (loss)	$19,440	$18,111	$31,031	$55,557
Other comprehensive income (loss) before taxes:				
Change in fair value of interest rate swap and rate cap agreements	747	4,197	2,891	(3,479)
Provision for income tax benefit (expense) related to components of other comprehensive income (loss)	(284)	(1,595)	(1,099)	1,322
Other comprehensive income (loss)	463	2,602	1,792	(2,157)
Comprehensive income (loss)	$19,903	$20,713	$32,823	$53,400

See notes to condensed consolidated financial statements.

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SONIC AUTOMOTIVE, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	September 30, 2017	December 31, 2016
	(Dollars in thousands)	
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 13,379	$ 3,108
Receivables, net	410,945	430,242
Inventories	1,390,053	1,570,701
Other current assets	18,399	26,993
Total current assets	1,832,776	2,031,044
Property and Equipment, net	1,120,811	1,010,380
Goodwill	526,918	472,437
Other Intangible Assets, net	78,350	80,233
Other Assets	55,714	45,242
Total Assets	$ 3,614,569	$ 3,639,336
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Notes payable - floor plan - trade	$ 718,959	$ 850,537
Notes payable - floor plan - non-trade	600,379	675,353
Trade accounts payable	102,122	117,740
Accrued interest	11,144	13,265
Other accrued liabilities	239,667	236,982
Current maturities of long-term debt	59,475	43,003
Total current liabilities	1,731,746	1,936,880
Long-Term Debt	1,016,390	839,675
Other Long-Term Liabilities	64,123	61,170
Deferred Income Taxes	79,336	76,447
Commitments and Contingencies		
Stockholders' Equity:		
Class A convertible preferred stock, none issued	-	-
Class A common stock, $0.01 par value; 100,000,000 shares authorized; 63,456,698 shares issued and 31,166,205 shares outstanding at September 30, 2017; 62,967,061 shares issued and 32,703,865 shares outstanding at December 31, 2016	635	630
Class B common stock, $0.01 par value; 30,000,000 shares authorized; 12,029,375 shares issued and outstanding at September 30, 2017	121	121

and December 31, 2016		
Paid-in capital	730,638	721,695
Retained earnings	565,563	541,146
Accumulated other comprehensive income (loss)	(470)	(2,262)
Treasury stock, at cost; 32,290,493 Class A common stock shares held at September 30, 2017 and 30,263,196 Class A common stock shares held at December 31, 2016	(573,513)	(536,166)
Total Stockholders' Equity	722,974	725,164
Total Liabilities and Stockholders' Equity	$3,614,569	$ 3,639,336

See notes to condensed consolidated financial statements.

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SONIC AUTOMOTIVE, INC.

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(Unaudited)

	Class A Common Stock		Class A Treasury Stock		Class B Common Stock		Paid-In	Retained	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
	Shares	Amount	Shares	Amount	Shares	Amount	Capital	Earnings		
	(In thousands)									
Balance at December 31, 2016	62,967	$630	(30,263)	$(536,166)	12,029	$121	$721,695	$541,146	$(2,262)	$725,164
Shares awarded under stock compensation plans	490	5	-	-	-	-	41	-	-	46
Purchases of treasury stock	-	-	(2,027)	(37,347)	-	-	-	-	-	(37,347)
Change in fair value of interest rate swap and rate cap agreements, net of tax expense of $1,099	-	-	-	-	-	-	-	-	1,792	1,792
Restricted stock amortization	-	-	-	-	-	-	8,902	-	-	8,902
Net income (loss)	-	-	-	-	-	-	-	31,031	-	31,031
Dividends declared	-	-	-	-	-	-	-	(6,614)	-	(6,614)
Balance at September 30, 2017	63,457	$635	(32,290)	$(573,513)	12,029	$121	$730,638	$565,563	$(470)	$722,974

See notes to condensed consolidated financial statements.

SONIC AUTOMOTIVE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended September 30,	
	2017	2016
	(In thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$31,031	$55,557
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization of property, plant and equipment	65,747	57,298
Provision for bad debt expense	657	260
Other amortization	487	487
Debt issuance cost amortization	1,784	1,886
Debt discount amortization, net of premium amortization	157	226
Stock-based compensation expense	8,902	8,394
Deferred income taxes	2,745	8,004
Net distributions from equity investee	17	(123)
Asset impairment charges	3,315	6,240
Loss (gain) on disposal of dealerships and property and equipment	(8,594)	(245)
Loss (gain) on exit of leased dealerships	2,016	1,109
Loss (gain) on retirement of debt	14,607	-
Changes in assets and liabilities that relate to operations:		
Receivables	24,330	85,708
Inventories	191,077	94,910
Other assets	(4,286)	63,763
Notes payable - floor plan - trade	(131,578)	(130,579)
Trade accounts payable and other liabilities	(14,282)	(11,362)
Total adjustments	157,101	185,976
Net cash provided by (used in) operating activities	188,132	241,533
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of businesses, net of cash acquired	(76,610)	(15,861)
Purchases of land, property and equipment	(181,893)	(155,060)
Proceeds from sales of property and equipment	392	1,050
Proceeds from sales of dealerships	22,578	-
Net cash provided by (used in) investing activities	(235,533)	(169,871)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net (repayments) borrowings on notes payable - floor plan - non-trade	(74,974)	(36,748)
Borrowings on revolving credit facilities	253,668	183,275
Repayments on revolving credit facilities	(118,668)	(187,478)
Proceeds from issuance of long-term debt	288,419	99,592
Debt issuance costs	(4,673)	(216)
Principal payments and repurchase of long-term debt	(31,194)	(25,735)

Repurchase of debt securities	(210,914)	-
Purchases of treasury stock	(37,347)	(97,486)
Income tax benefit (expense) associated with stock compensation plans	-	(1,101)
Issuance of shares under stock compensation plans	46	9
Dividends paid	(6,691)	(6,458)
Net cash provided by (used in) financing activities	57,672	(72,346)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	10,271	(684)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	3,108	3,625
CASH AND CASH EQUIVALENTS, END OF PERIOD	$13,379	$2,941

SUPPLEMENTAL SCHEDULE OF NON-CASH FINANCING ACTIVITIES:		
Change in fair value of interest rate swap and rate cap agreements (net of tax expense of $1,099 and benefit of $1,322 in the nine months ended September 30, 2017 and 2016, respectively)	$1,792	$(2,157)
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid (received) during the period for:		
Interest, including amount capitalized	$67,523	$57,149
Income taxes	$30,752	$26,922

See notes to condensed consolidated financial statements.

SONIC AUTOMOTIVE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Basis of Presentation – The accompanying condensed consolidated financial statements of Sonic Automotive, Inc. and its wholly owned subsidiaries (“Sonic,” the “Company,” “we,” “us” and “our”) for the three and nine months ended September 30, 2017 and 2016 are unaudited and have been prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”) for interim financial information and applicable rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. These unaudited condensed consolidated financial statements reflect, in the opinion of management, all material normal recurring adjustments necessary to fairly state the financial position, results of operations and cash flows for the periods presented. The operating results for interim periods are not necessarily indicative of the results to be expected for the entire fiscal year or future interim periods, because the first quarter normally contributes less operating profit than the second, third and fourth quarters. These interim financial statements should be read in conjunction with the consolidated financial statements and related notes thereto included in Sonic’s Annual Report on Form 10-K for the year ended December 31, 2016.

Recent Accounting Pronouncements – In May 2014, the Financial Accounting Standards Board (the “FASB”) issued Accounting Standards Update (“ASU”) 2014-09 to amend the accounting guidance on revenue recognition. The amendments in this ASU are intended to provide a more robust framework for addressing revenue issues, improve comparability of revenue recognition practices and improve disclosure requirements. The amendments in this ASU must be applied using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients or (ii) a modified retrospective approach with the cumulative effect of initially adopting the standard recognized at the date of adoption (which requires additional footnote disclosures). This ASU is effective for reporting periods beginning after December 15, 2017. Earlier application is permitted only as of reporting periods beginning after December 15, 2016. Sonic plans to adopt this ASU effective January 1, 2018 and anticipates adopting the modified retrospective transition approach. While management is still evaluating the specific financial statement impact and quantitative and qualitative disclosure impact of the provisions of this ASU, management generally expects similar performance obligations to result under this ASU as compared with deliverables and separate units of accounting under current U.S. GAAP and does not expect the adoption of this standard to have a material impact on its financial statements, revenue recognition practices or internal controls. As a result, management expects the amounts and timing of revenue recognition to generally remain the same, with the exception of the timing of revenue recognition related to service and collision repair orders that are incomplete as of a reporting date and certain finance and insurance income earned in periods subsequent to the completion of the initial performance obligation, neither of which are expected to have a material impact on reported results of operations.

In February 2016, the FASB issued ASU 2016-02 to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The amendments in this ASU require that leases are classified as either finance or operating leases, a right-of-use asset and lease liability is recognized in the statement of financial position, and repayments are classified within operating activities in the statement of cash flows. The amendments in this ASU are to be applied using a modified retrospective approach and are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018 (early adoption is permitted). Sonic plans to adopt this ASU effective January 1, 2019. While management is still evaluating the impact of adopting the provisions of this ASU, management expects that upon adoption of this ASU, the presentation of certain items in Sonic’s consolidated financial position, cash flows and other disclosures will be materially impacted, primarily due to the recognition of a right-of-use asset and an associated liability and a change in the timing and classification of certain items in Sonic’s results of operations as a result of the derecognition of the lease liability.

In March 2016, the FASB issued ASU 2016-09 to simplify several aspects of the accounting for share-based payment transactions. For public companies, this ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016 (early adoption is permitted). Sonic adopted this ASU effective January 1, 2017. Upon adoption of this ASU, interim period and annual income tax expense is affected by stock option exercises and restricted stock and restricted stock unit vesting activity, potentially creating volatility in Sonic’s effective income tax rate from period to period. See the heading “Income Tax Expense” below for further discussion of the impact of the adoption of this ASU on Sonic’s effective income tax rate for the three and nine months ended September 30, 2017.

In August 2016, the FASB issued ASU 2016-15 related to the classification of certain cash receipts and cash payments on the statement of cash flows. For public companies, this ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017 (early adoption is permitted). Sonic plans to adopt this ASU effective January 1, 2018. Upon adoption of this ASU, the presentation of certain items in Sonic’s cash flows and other disclosures may be impacted.

SONIC AUTOMOTIVE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

In August 2017, the FASB issued ASU 2017-12 which amends the hedge accounting recognition and presentation requirements in ASC 815. This ASU expands and refines hedge accounting for both nonfinancial and financial risk components and aligns the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements. It also includes certain targeted improvements to simplify the application of current guidance related to hedge accounting. For public companies, this ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018 (early adoption is permitted). Sonic is currently in the process of evaluating the effects of this pronouncement on its consolidated financial statements.

Principles of Consolidation – All of Sonic's subsidiaries are wholly owned and consolidated in the accompanying condensed consolidated financial statements, except for one 50%-owned dealership that is accounted for under the equity method. All material intercompany balances and transactions have been eliminated in the accompanying condensed consolidated financial statements.

Lease Exit Accruals – Lease exit accruals relate to facilities Sonic has ceased using in its operations that remain subject to a current lease agreement. The accruals represent the present value of the lease payments, net of estimated or actual sublease proceeds, for the remaining life of the operating leases and other accruals necessary to satisfy the lease commitment to the landlord. These situations could include the relocation of an existing facility or the sale of a dealership when the buyer will not be subleasing the property for either the remaining term of the lease or for an amount of rent equal to Sonic's obligation under the lease, or situations in which a store is closed as a result of the associated franchise being terminated by Sonic or the manufacturer and no other operations continue on the leased property. See Note 12, "Commitments and Contingencies," to the consolidated financial statements in Sonic's Annual Report on Form 10-K for the year ended December 31, 2016 for further discussion.

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

	(In thousands)
Balance at December 31, 2016	$ 9,790
Lease exit expense (1)	2,016
Payments (2)	(2,671)
Other (3)	(1,377)
Balance at September 30, 2017	$ 7,758

(1) Expense of approximately $0.1 million is recorded in interest expense, other, net and expense of approximately $0.8 million is recorded in selling, general and administrative expenses in the accompanying condensed consolidated statements of income. In addition, expense of approximately $1.1 million is recorded in income (loss) from discontinued operations before taxes in the accompanying condensed consolidated statements of income.

(2) Amount is recorded as an offset to rent expense, with approximately $0.7 million recorded in selling, general and administrative expenses in the accompanying condensed consolidated statements of income and approximately $2.0 million recorded in income (loss) from discontinued operations before taxes in the accompanying condensed consolidated statements of income.

(3)

Amount represents the cash settlement of accruals related to certain deferred maintenance costs and other liabilities related to lease termination.

Income Tax Expense – The overall effective tax rate from continuing operations was 41.7% and 41.0% for the three and nine months ended September 30, 2017, respectively, and was 39.3% for both the three and nine months ended September 30, 2016. Income tax expense for the three and nine months ended September 30, 2017 includes a $0.4 million discrete charge related to a non-deductible asset impairment charge. Income tax expense for the nine months ended September 30, 2017 includes a benefit of approximately $0.5 million as a result of the adoption of ASU 2016-09 discussed above. Sonic's effective tax rate varies from year to year based on the distribution of taxable income between states in which Sonic operates and other tax adjustments. Sonic expects the effective tax rate in future periods to fall within a range of 38.0% to 40.0% before the impact, if any, of changes in valuation allowances related to deferred income tax assets or discrete tax adjustments.

2. Business Acquisitions and Dispositions

Acquisitions – During the three months ended September 30, 2017, Sonic acquired a stand-alone pre-owned vehicle business for approximately $76.6 million. During the nine months ended September 30, 2016, Sonic acquired three stand-alone pre-owned vehicle businesses and related real estate for approximately $15.9 million.

SONIC AUTOMOTIVE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Dispositions – Sonic disposed of one mid-line import franchise during the three months ended September 30, 2017 that generated net cash of approximately $22.6 million. Sonic did not dispose of any franchises during the nine months ended September 30, 2016.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
	(In thousands)			
Income (loss) from operations	$(119)	$(212)	$(561)	$(539)
Lease exit accrual adjustments and charges	(362)	(1,201)	(1,089)	(974)
Pre-tax income (loss)	$(481)	$(1,413)	$(1,650)	$(1,513)
Total revenues	$-	$-	$-	$-

Revenues and other activities associated with disposed dealerships that remain in continuing operations were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
	(In thousands)			
Income (loss) from operations	$(70)	$160	$203	$124
Gain (loss) on disposal	8,490	29	8,466	(30)
Pre-tax income (loss)	$8,420	$189	$8,669	$94
Total revenues	$7,082	$17,679	$36,447	$49,778

3. Inventories

Inventories consist of the following:

	September 30, 2017	December 31, 2016
	(In thousands)	
New vehicles	$894,382	$ 1,088,814
Used vehicles	296,929	282,288

Service loaners	130,657	128,821
Parts, accessories and other	68,085	70,778
Net inventories	$1,390,053	$ 1,570,701

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SONIC AUTOMOTIVE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

4. Property and Equipment

Property and equipment, net consists of the following:

	September 30, 2017	December 31, 2016
	(In thousands)	
Land	$ 351,367	$ 306,457
Building and improvements	869,382	777,766
Software and computer equipment	143,239	128,366
Parts and service equipment	104,483	93,901
Office equipment and fixtures	95,236	86,216
Company vehicles	9,595	9,107
Construction in progress	61,676	62,982
Total, at cost	1,634,978	1,464,795
Less accumulated depreciation	(510,678)	(450,184)
Subtotal	1,124,300	1,014,611
Less assets held for sale (1)	(3,489)	(4,231)
Property and equipment, net	$ 1,120,811	$ 1,010,380

(1)Classified in other current assets in the accompanying condensed consolidated balance sheets.

In the three and nine months ended September 30, 2017, capital expenditures were approximately $60.7 million and $181.9 million, respectively, and in the three and nine months ended September 30, 2016, capital expenditures were approximately $46.1 million and $155.1 million, respectively. Capital expenditures in all periods were primarily related to real estate acquisitions, construction of new franchised dealerships and pre-owned stores, building improvements and equipment purchased for use in Sonic’s franchised dealerships and pre-owned stores. Assets held for sale as of September 30, 2017 and December 31, 2016 consists of vacant land that Sonic expects to dispose of in the next 12 months.

Impairment charges for the three and nine months ended September 30, 2017 were approximately $0.2 million and $3.3 million, respectively, which include the write-off of goodwill and property and equipment as part of the closure of two stand-alone pre-owned stores that were purchased in 2016, and the write-off of costs associated with certain construction projects. Impairment charges for the three and nine months ended September 30, 2016 were approximately $6.1 million and $6.2 million, respectively, related to the write-off of property and equipment to be demolished in conjunction with a facility construction project and the write-off of costs associated with certain construction projects.

5. Goodwill and Intangible Assets

The carrying amount of goodwill was approximately $526.9 million and $472.4 million, as of September 30, 2017 and December 31, 2016, respectively. Sonic allocated approximately $60.0 million of goodwill to the current year acquisition, reduced goodwill by approximately $4.6 million for the disposition of a dealership and impaired approximately $0.9 million of goodwill in the nine months ended September 30, 2017 related to the closure of two stand-alone pre-owned stores that were purchased in 2016. The carrying amount of goodwill is net of accumulated impairment losses of approximately $797.6 million and $796.7 million, as of September 30, 2017 and December 31, 2016, respectively. The carrying amount of franchise assets was approximately $73.5 million and $74.9 million, as of September 30, 2017 and December 31, 2016, respectively. Sonic reduced franchise assets by approximately $1.4 million for the disposition of a dealership in the nine months ended September 30, 2017.

At December 31, 2016, Sonic had approximately $5.3 million of definite life intangibles related to favorable lease agreements. After the effect of amortization of the definite life intangibles, the balance recorded at September 30, 2017 was approximately $4.9 million. Both franchise assets and favorable lease agreement assets are included in other intangible assets, net in the accompanying condensed consolidated balance sheets.

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6. Long-Term Debt

Long-term debt consists of the following:

	September 30, 2017	December 31, 2016
	(In thousands)	
2016 Revolving Credit Facility (1)	$ 135,000	$ -
7.0% Senior Subordinated Notes due 2022 (the “7.0% Notes”)	-	200,000
5.0% Senior Subordinated Notes due 2023 (the “5.0% Notes”)	289,273	289,273
6.125% Senior Subordinated Notes due 2027 (the “6.125% Notes”)	250,000	-
Mortgage notes to finance companies-fixed rate, bearing interest from 3.51% to 7.03%	197,053	176,369
Mortgage notes to finance companies-variable rate, bearing interest at 1.50 to 2.90 percentage points above one-month or three-month LIBOR	214,132	227,342
Net debt discount and premium (2)	-	(1,258)
Debt issuance costs	(13,625)	(13,328)
Other	4,032	4,280
Total debt	$ 1,075,865	$ 882,678
Less current maturities	(59,475)	(43,003)
Long-term debt	$ 1,016,390	$ 839,675

(1) The interest rate on the 2016 Revolving Credit Facility (as defined below) was 225 basis points above LIBOR for both September 30, 2017 and December 31, 2016.

(2) December 31, 2016 includes a $1.1 million discount associated with the 7.0% Notes and a $0.2 million discount associated with mortgage notes payable.

2016 Credit Facilities

On November 30, 2016, Sonic entered into an amended and restated syndicated revolving credit facility (the “2016 Revolving Credit Facility”) and amended and restated syndicated new and used vehicle floor plan credit facilities (the “2016 Floor Plan Facilities” and, together with the 2016 Revolving Credit Facility, the “2016 Credit Facilities”), which are scheduled to mature on November 30, 2021.

Availability under the 2016 Revolving Credit Facility is calculated as the lesser of $250.0 million or a borrowing base calculated based on certain eligible assets, less the aggregate face amount of any outstanding letters of credit under the 2016 Revolving Credit Facility (the “2016 Revolving Borrowing Base”). The 2016 Revolving Credit Facility may be increased at Sonic’s option up to $300.0 million upon satisfaction of certain conditions. Based on balances as of September 30, 2017, the 2016 Revolving Borrowing Base was approximately $236.3 million. As of September 30, 2017, Sonic had $135.0 million outstanding borrowings and approximately $17.3 million in outstanding letters of credit under the 2016 Revolving Credit Facility, resulting in total borrowing availability of $84.0 million under the 2016 Revolving Credit Facility.

7.0% Notes

On July 2, 2012, Sonic issued $200.0 million in aggregate principal amount of unsecured senior subordinated 7.0% Notes which were scheduled to mature on July 15, 2022.

On March 27, 2017, Sonic repurchased all of the outstanding 7.0% Notes using net proceeds from the issuance of the 6.125% Notes. Sonic paid approximately $213.7 million in cash, including an early redemption premium and accrued and unpaid interest, to extinguish the 7.0% Notes and recognized a loss of approximately $14.6 million on the repurchase of the 7.0% Notes, recorded in other income (expense), net in the accompanying condensed consolidated statements of income.

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5.0% Notes

On May 9, 2013, Sonic issued $300.0 million in aggregate principal amount of unsecured senior subordinated 5.0% Notes which mature on May 15, 2023. The 5.0% Notes were issued at a price of 100.0% of the principal amount thereof. The 5.0% Notes are guaranteed by Sonic’s domestic operating subsidiaries. Interest on the 5.0% Notes is payable semi-annually in arrears on May 15 and November 15 of each year. On September 30, 2016, Sonic repurchased approximately $10.7 million of its outstanding 5.0% Notes for approximately $10.6 million in cash, plus accrued and unpaid interest related thereto. See Note 6, “Long-Term Debt,” to the consolidated financial statements in Sonic’s Annual Report on Form 10-K for the year ended December 31, 2016 for further discussion.

6.125% Notes

On March 10, 2017, Sonic issued $250.0 million in aggregate principal amount of unsecured senior subordinated 6.125% Notes which mature on March 15, 2027. The 6.125% Notes were issued at a price of 100.0% of the principal amount thereof. Sonic used the net proceeds from the issuance of the 6.125% Notes to repurchase all of the outstanding 7.0% Notes on March 27, 2017. Remaining proceeds from the issuance of the 6.125% Notes will be used for general corporate purposes. The 6.125% Notes are guaranteed by Sonic’s domestic operating subsidiaries. Interest on the 6.125% Notes is payable semi-annually in arrears on March 15 and September 15 of each year. Sonic may redeem the 6.125% Notes, in whole or in part, at any time on or after March 15, 2022 at the following redemption prices, which are expressed as percentages of the principal amount:

	Redemption Price	
Beginning on March 15, 2022	103.063	%
Beginning on March 15, 2023	102.042	%
Beginning on March 15, 2024	101.021	%
Beginning on March 15, 2025 and thereafter	100.000	%

Before March 15, 2022, Sonic may redeem all or a part of the 6.125% Notes at a redemption price equal to 100.0% of the principal amount of the 6.125% Notes redeemed, plus the Applicable Premium (as defined in the indenture governing the 6.125% Notes) and any accrued and unpaid interest, if any, to the redemption date. In addition, on or before March 15, 2020, Sonic may redeem up to 35% of the aggregate principal amount of the 6.125% Notes at a redemption price equal to 106.125% of the par value of the 6.125% Notes redeemed, plus accrued and unpaid interest, if any, to the redemption date with proceeds from certain equity offerings. The indenture governing the 6.125% Notes also provides that holders of the 6.125% Notes may require Sonic to repurchase the 6.125% Notes at a purchase price equal to 101.0% of the par value of the 6.125% Notes, plus accrued and unpaid interest, if any, to the date of purchase if Sonic undergoes a Change of Control (as defined in the indenture governing the 6.125% Notes).

The indenture governing the 6.125% Notes contains certain specified restrictive covenants. Sonic has agreed not to pledge any assets to any third-party lender of senior subordinated debt except under certain limited circumstances. Sonic also has agreed to certain other limitations or prohibitions concerning the incurrence of other indebtedness, guarantees, liens, certain types of investments, certain transactions with affiliates, mergers, consolidations, issuance of preferred stock, cash dividends to stockholders, distributions, redemptions and the sale, assignment, lease, conveyance or disposal of certain assets. Specifically, the indenture governing the 6.125% Notes limits Sonic’s ability to pay quarterly cash dividends on Sonic’s Class A and Class B common stock in excess of $0.12 per share. Sonic may only pay quarterly cash dividends on Sonic’s Class A and Class B common stock if Sonic complies with the terms of the indenture governing the 6.125% Notes. Sonic was in compliance with all restrictive covenants in the indenture governing the 6.125% Notes as of September 30, 2017.

Sonic’s obligations under the 6.125% Notes may be accelerated by the holders of 25% of the outstanding principal amount of the 6.125% Notes then outstanding if certain events of default occur, including: (1) defaults in the payment of principal or interest when due; (2) defaults in the performance, or breach, of Sonic’s covenants under the 6.125% Notes; and (3) certain defaults under other agreements under which Sonic or its subsidiaries have outstanding indebtedness in excess of $50.0 million.

Mortgage Notes

During the nine months ended September 30, 2017, Sonic obtained approximately $38.4 million in mortgage financing related to seven of its operating locations. As of September 30, 2017, the weighted average interest rate was 4.01% and the total outstanding principal balance was approximately $411.2 million, related to approximately 45% of Sonic’s operating locations. These mortgage

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notes require monthly payments of principal and interest through their respective maturities and are secured by the underlying properties. Maturity dates for these mortgage notes range between 2017 and 2033.

Covenants

Sonic agreed under the 2016 Credit Facilities not to pledge any assets to any third party (other than those explicitly allowed under the amended terms of the 2016 Credit Facilities), including other lenders, subject to certain stated exceptions, including floor plan financing arrangements. In addition, the 2016 Credit Facilities contain certain negative covenants, including covenants which could restrict or prohibit the payment of dividends, capital expenditures and material dispositions of assets, as well as other customary covenants and default provisions.

Sonic was in compliance with the covenants under the 2016 Credit Facilities as of September 30, 2017. Financial covenants include required specified ratios (as each is defined in the 2016 Credit Facilities) of:

	Covenant		
	Minimum Consolidated Liquidity Ratio	Minimum Consolidated Fixed Charge Coverage Ratio	Maximum Consolidated Total Lease Adjusted Leverage Ratio
Required ratio	1.05	1.20	5.75
September 30, 2017 actual	1.12	1.75	4.84

The 2016 Credit Facilities contain events of default, including cross defaults to other material indebtedness, change of control events and other events of default customary for syndicated commercial credit facilities. Upon the future occurrence of an event of default, Sonic could be required to immediately repay all outstanding amounts under the 2016 Credit Facilities.

After giving effect to the applicable restrictions on the payment of dividends under its debt agreements, as of September 30, 2017, Sonic had approximately $113.6 million of net income and retained earnings free of such restrictions. Sonic was in compliance with all restrictive covenants as of September 30, 2017.

In addition, many of Sonic's facility leases are governed by a guarantee agreement between the landlord and Sonic that contains financial and operating covenants. The financial covenants under the guarantee agreement are identical to those under the 2016 Credit Facilities with the exception of one financial covenant related to the ratio of EBTDAR to Rent (as defined in the guarantee agreement) with a required ratio of no less than 1.50 to 1.00. As of September 30, 2017, the ratio was 3.83 to 1.00.

Derivative Instruments and Hedging Activities

Sonic has interest rate cash flow swap agreements to effectively convert a portion of its LIBOR-based variable rate debt to a fixed rate. In addition, Sonic has interest rate cap agreements to limit its exposure to increases in LIBOR rates above certain levels. Under the terms of these cash flow swaps and interest rate caps, interest rates reset monthly. The fair value of these interest rate swap and rate cap positions at September 30, 2017 was a net asset of approximately $1.4 million, with approximately $3.8 million included in other assets and approximately $0.5 million included in other current assets in the accompanying condensed consolidated balance sheets, offset partially by approximately $1.8 million included in other accrued liabilities and approximately $1.1 million included in other long-term liabilities in the accompanying condensed consolidated balance sheets. The fair value of the interest rate swap positions at December 31, 2016 was a net liability of approximately $3.7 million, with approximately $4.1 million included in other accrued liabilities and approximately $2.4 million included in other long-term liabilities in the accompanying condensed consolidated balance sheets, offset partially by approximately $2.8 million included in other assets in the accompanying condensed consolidated balance sheets.

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Under the terms of these cash flow swaps, Sonic will receive and pay interest based on the following:

Notional Amount (In millions)		Pay Rate	Receive Rate (1)	Maturing Date
$ 6.8		4.655%	one-month LIBOR	December 10, 2017
$ 250.0		1.887%	one-month LIBOR	June 30, 2018
$ 125.0		1.900%	one-month LIBOR	July 1, 2018
$ 50.0	(2)	2.320%	one-month LIBOR	July 1, 2019
$ 200.0	(2)	2.313%	one-month LIBOR	July 1, 2019
$ 100.0	(3)	1.384%	one-month LIBOR	July 1, 2020
$ 125.0	(2)	1.158%	one-month LIBOR	July 1, 2019
$ 150.0	(3)	1.310%	one-month LIBOR	July 1, 2020
$ 125.0		1.020%	one-month LIBOR	July 1, 2018
$ 62.5	(4)	2.000%	one-month LIBOR	July 1, 2021
$ 62.5	(4)	2.000%	one-month LIBOR	July 1, 2021
$ 62.5	(4)	2.000%	one-month LIBOR	July 1, 2021
$ 62.5	(4)	2.000%	one-month LIBOR	July 1, 2021

(1) The one-month LIBOR rate was approximately 1.232% at September 30, 2017.
(2) The effective date of these forward-starting swaps is July 2, 2018.
(3) The effective date of these forward-starting swaps is July 1, 2019.
(4) The notional amount of these interest rate caps adjusts over the term of the agreement as follows: $62.5 million from September 1, 2017 to June 30, 2018, $93.75 million from July 1, 2018 to June 30, 2019, $78.125 million from July 1, 2019 to June 30, 2020, and $37.5 million from July 1, 2020 to July 1, 2021.

Sonic previously had non-hedging swaps that have matured, but the instruments impact on the income statement is as follows: for the interest rate swaps not designated as cash flow hedges, the changes in the fair value of these swaps are recognized through earnings and are included in interest expense, other, net in the accompanying condensed consolidated statements of income. For the three and nine months ended September 30, 2017, these items were a benefit of approximately $0.1 million and $0.3 million, respectively, and for the three and nine months ended September 30, 2016, these items were a benefit of approximately $0.2 million and $0.4 million, respectively.

For the interest rate swaps and rate caps that qualify as cash flow hedges, the changes in the fair value of these instruments are recorded in other comprehensive income (loss) in the accompanying condensed consolidated statements of comprehensive income and are disclosed in the supplemental schedule of non-cash financing activities in the accompanying condensed consolidated statements of cash flows. The incremental interest expense (the difference between interest paid and interest received) related to these instruments was approximately $0.7 million and $2.6 million for the three and nine months ended September 30, 2017, respectively, and approximately

$1.5 million and $4.1 million for the three and nine months ended September 30, 2016, respectively, and is included in interest expense, other, net in the accompanying condensed consolidated statements of income and the interest paid amount is disclosed in the supplemental disclosures of cash flow information in the accompanying condensed consolidated statements of cash flows. The estimated net expense expected to be reclassified out of accumulated other comprehensive income (loss) into results of operations during the next 12 months is approximately $0.8 million.

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7. Per Share Data and Stockholders' Equity

The calculation of diluted earnings per share considers the potential dilutive effect of stock options and shares under Sonic's stock compensation plans. Certain of Sonic's non-vested restricted stock awards contain rights to receive non-forfeitable dividends and, thus, are considered participating securities and are included in the two-class method of computing earnings per share. The following tables illustrate the dilutive effect of such items on earnings per share for the three and nine months ended September 30, 2017 and 2016:

	Three Months Ended September 30, 2017						
		Income (Loss) From Continuing Operations		Income (Loss) From Discontinued Operations		Net Income (Loss)	
	Weighted Average Shares	Amount	Per Share Amount	Amount	Per Share Amount	Amount	Per Share Amount
	(In thousands, except per share amounts)						
Earnings (loss) and shares	43,496	$19,730		$(290)		$19,440	
Effect of participating securities:							
Non-vested restricted stock		(18)		-		(18)	
Basic earnings (loss) and shares	43,496	$19,712	$ 0.45	$(290)	$ -	$19,422	$ 0.45
Effect of dilutive securities:							
Stock compensation plans	315						
Diluted earnings (loss) and shares	43,811	$19,712	$ 0.45	$(290)	$ (0.01)	$19,422	$ 0.44

	Three Months Ended September 30, 2016						
		Income (Loss) From Continuing Operations		Income (Loss) From Discontinued Operations		Net Income (Loss)	
	Weighted Average Shares	Amount	Per Share Amount	Amount	Per Share Amount	Amount	Per Share Amount
	(In thousands, except per share amounts)						
Earnings (loss) and shares	45,118	$18,969		$(858)		$18,111	
Effect of participating securities:							
Non-vested restricted stock		(11)		-		(11)	
Basic earnings (loss) and shares	45,118	$18,958	$ 0.42	$(858)	$ (0.02)	$18,100	$ 0.40
Effect of dilutive securities:							
Stock compensation plans	236						
Diluted earnings (loss) and shares	45,354	$18,958	$ 0.42	$(858)	$ (0.02)	$18,100	$ 0.40

Nine Months Ended September 30, 2017

		Income (Loss) From Continuing Operations		Income (Loss) From Discontinued Operations		Net Income (Loss)	
	Weighted Average Shares	Amount	Per Share Amount	Amount	Per Share Amount	Amount	Per Share Amount
	(In thousands, except per share amounts)						
Earnings (loss) and shares	44,281	$32,024		$(993)		$31,031	
Effect of participating securities:							
Non-vested restricted stock		(28)		-		(28)	
Basic earnings (loss) and shares	44,281	$31,996	$ 0.72	$(993)	$ (0.02)	$31,003	$ 0.70
Effect of dilutive securities:							
Stock compensation plans	304						
Diluted earnings (loss) and shares	44,585	$31,996	$ 0.72	$(993)	$ (0.02)	$31,003	$ 0.70

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	Nine Months Ended September 30, 2016						
		Income (Loss) From Continuing Operations		Income (Loss) From Discontinued Operations		Net Income (Loss)	
	Weighted Average Shares	Amount	Per Share Amount	Amount	Per Share Amount	Amount	Per Share Amount
	(In thousands, except per share amounts)						
Earnings (loss) and shares	45,930	$56,475		$(918)		$55,557	
Effect of participating securities:							
Non-vested restricted stock		(31)		-		(31)	
Basic earnings (loss) and shares	45,930	$56,444	$ 1.23	$(918)	$ (0.02)	$55,526	$ 1.21
Effect of dilutive securities:							
Stock compensation plans	200						
Diluted earnings (loss) and shares	46,130	$56,444	$ 1.22	$(918)	$ (0.02)	$55,526	$ 1.20

8. Contingencies

Legal and Other Proceedings

Sonic is involved, and expects to continue to be involved, in various legal and administrative proceedings arising out of the conduct of its business, including regulatory investigations and private civil actions brought by plaintiffs purporting to represent a potential class or for which a class has been certified. Although Sonic vigorously defends itself in all legal and administrative proceedings, the outcomes of pending and future proceedings arising out of the conduct of Sonic's business, including litigation with customers, employment-related lawsuits, contractual disputes, class actions, purported class actions and actions brought by governmental authorities, cannot be predicted with certainty. An unfavorable resolution of one or more of these matters could have a material adverse effect on Sonic's business, financial condition, results of operations, cash flows or prospects.

Included in other accrued liabilities and other long-term liabilities at September 30, 2017 was approximately $3.0 million and $0.2 million, respectively, in reserves that Sonic was holding for pending proceedings. Included in other accrued liabilities and other long-term liabilities at December 31, 2016 was approximately $0.3 million and $0.2 million, respectively, for such reserves. Except as reflected in such reserves, Sonic is currently unable to estimate a range of reasonably possible loss, or a range of reasonably possible loss in excess of the amount accrued, for pending proceedings.

Guarantees and Indemnification Obligations

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

In connection with dealership dispositions and facility relocations, certain of Sonic's subsidiaries have assigned or sublet to the buyer their interests in real property leases associated with such dealerships. In general, the subsidiaries retain responsibility for the performance of certain obligations under such leases, including rent payments and repairs to leased property upon termination of the lease, to the extent that the assignee or sublessee does not perform. In the event a sublessee does not perform its obligations, Sonic remains liable for the lease payments. See Note 12, "Commitments and Contingencies," to the consolidated financial statements in Sonic's Annual Report on Form 10-K for the year ended December 31, 2016 for further discussion.

In accordance with the terms of agreements entered into for the sale of Sonic's dealerships, Sonic generally agrees to indemnify the buyer from certain liabilities and costs arising subsequent to the date of sale, including environmental exposure and exposure resulting from the breach of representations or warranties made in accordance with the agreements. While Sonic's exposure with respect to environmental remediation and repairs is difficult to quantify, Sonic's maximum exposure associated with these general indemnifications was approximately $0.5 million at both September 30, 2017 and December 31, 2016. These indemnifications typically expire within a period of one to three years following the date of sale. The estimated fair value of these indemnifications was not material and the amount recorded for this contingency was not significant at September 30, 2017.

Sonic also guarantees the floor plan commitments of its 50%-owned joint venture, the amount of which was approximately $2.8 million at both September 30, 2017 and December 31, 2016.

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Earnout Consideration

In association with the acquisition of a business, Sonic entered into an earnout agreement whereby the seller may be entitled to certain earnout payments based on the acquired business achieving certain earnings targets over a 10-year period, not to exceed a maximum aggregate earnout payment of $80.0 million. As management has not yet finalized the purchase accounting estimates for this acquisition, the estimated fair value of this earnout agreement and the amount recorded for this contingency have not yet been determined.

9. Fair Value Measurements

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

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

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

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

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

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

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Assets and liabilities recorded at fair value in the accompanying condensed consolidated balance sheets as of September 30, 2017 and December 31, 2016 are as follows:

	Fair Value Based on Significant Other Observable Inputs (Level 2)	
	September 30, 2017	December 31, 2016
	(In thousands)	
Assets:		
Cash surrender value of life insurance policies (1)	$32,745	$ 31,475
Cash flow swaps and interest rate caps designated as hedges (2)	4,290	2,772
Total assets	$37,035	$ 34,247
Liabilities:		
Cash flow swaps and interest rate caps designated as hedges (3)	$2,903	$ 6,135
Cash flow swaps not designated as hedges (4)	-	346
Deferred compensation plan (5)	17,216	14,824
Total liabilities	$20,119	$ 21,305

(1) Included in other assets in the accompanying condensed consolidated balance sheets.

(2) As of September 30, 2017, approximately $0.5 million and $3.8 million were included in other current assets and other assets, respectively, in the accompanying condensed consolidated balance sheets. As of December 31, 2016, approximately $2.8 million was included in other assets in the accompanying condensed consolidated balance sheets.

(3) As of September 30, 2017, approximately $1.8 million and $1.1 million were included in other accrued liabilities and other long-term liabilities, respectively, in the accompanying condensed consolidated balance sheets. As of December 31, 2016, approximately $3.7 million and $2.4 million were included in other accrued liabilities and other long-term liabilities, respectively, in the accompanying condensed consolidated balance sheets.

(4) Included in other accrued liabilities in the accompanying condensed consolidated balance sheets.

(5) Included in other long-term liabilities in the accompanying condensed consolidated balance sheets.