

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 August 31, 2018

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

(State or other jurisdiction of
incorporation or organization)

54-1821055

(I.R.S. Employer
Identification No.)

12800 TUCKAHOE CREEK PARKWAY, RICHMOND, VIRGINIA

(Address of principal executive offices)

23238

(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

No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files).

Yes

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

Accelerated filer

Non-accelerated filer

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
Common Stock, par value \$0.50

Outstanding as of September 28, 2018
174,621,243

CARMAX, INC. AND SUBSIDIARIES

TABLE OF CONTENTS

| | Page No. |
|--|---------------------------|
| PART I. | |
| <u>FINANCIAL INFORMATION</u> | |
| Item 1. Financial Statements: | |
| Consolidated Statements of Earnings (Unaudited) – Three and Six Months Ended August 31, 2018 and 2017 | <u>3</u> |
| Consolidated Statements of Comprehensive Income (Unaudited) – Three and Six Months Ended August 31, 2018 and 2017 | <u>4</u> |
| Consolidated Balance Sheets (Unaudited) – August 31, 2018 and February 28, 2018 | <u>5</u> |
| Consolidated Statements of Cash Flows (Unaudited) – Six Months Ended August 31, 2018 and 2017 | <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>21</u> |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk | <u>36</u> |
| Item 4. Controls and Procedures | <u>36</u> |
| PART II. | |
| <u>OTHER INFORMATION</u> | |
| Item 1. Legal Proceedings | <u>37</u> |
| Item 1A. Risk Factors | <u>37</u> |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds | <u>37</u> |
| Item 6. Exhibits | <u>38</u> |
| <u>SIGNATURES</u> | <u>39</u> |

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CARMAX, INC. AND SUBSIDIARIES

Consolidated Statements of Earnings

(Unaudited)

| <i>(In thousands except per share data)</i> | Three Months Ended August 31 | | | | Six Months Ended August 31 | | | |
|--|------------------------------|------------------|-------------------|------------------|----------------------------|------------------|-------------------|------------------|
| | 2018 | % ⁽¹⁾ | 2017 | % ⁽¹⁾ | 2018 | % ⁽¹⁾ | 2017 | % ⁽¹⁾ |
| SALES AND OPERATING REVENUES: | | | | | | | | |
| Used vehicle sales | \$ 3,975,368 | 83.4 | \$ 3,694,200 | 84.2 | \$ 7,996,415 | 83.7 | \$ 7,537,573 | 84.4 |
| Wholesale vehicle sales | 627,990 | 13.2 | 547,767 | 12.5 | 1,245,641 | 13.0 | 1,101,157 | 12.3 |
| Other sales and revenues | 162,677 | 3.4 | 144,673 | 3.3 | 316,571 | 3.3 | 290,244 | 3.3 |
| NET SALES AND OPERATING REVENUES | 4,766,035 | 100.0 | 4,386,640 | 100.0 | 9,558,627 | 100.0 | 8,928,974 | 100.0 |
| COST OF SALES: | | | | | | | | |
| Used vehicle cost of sales | 3,546,383 | 74.4 | 3,289,051 | 75.0 | 7,127,992 | 74.6 | 6,700,497 | 75.0 |
| Wholesale vehicle cost of sales | 516,913 | 10.8 | 447,490 | 10.2 | 1,019,858 | 10.7 | 896,208 | 10.0 |
| Other cost of sales | 52,103 | 1.1 | 46,094 | 1.1 | 98,801 | 1.0 | 79,326 | 0.9 |
| TOTAL COST OF SALES | 4,115,399 | 86.3 | 3,782,635 | 86.2 | 8,246,651 | 86.3 | 7,676,031 | 86.0 |
| GROSS PROFIT | 650,636 | 13.7 | 604,005 | 13.8 | 1,311,976 | 13.7 | 1,252,943 | 14.0 |
| CARMAX AUTO FINANCE INCOME | | | | | | | | |
| Selling, general and administrative expenses | 453,554 | 9.5 | 405,062 | 9.2 | 891,788 | 9.3 | 808,565 | 9.1 |
| Interest expense | 17,950 | 0.4 | 16,836 | 0.4 | 36,002 | 0.4 | 33,674 | 0.4 |
| Other (income) expense | (686) | — | (189) | — | 277 | — | (282) | — |
| Earnings before income taxes | 289,485 | 6.1 | 290,232 | 6.6 | 609,169 | 6.4 | 628,285 | 7.0 |
| Income tax provision | 68,595 | 1.4 | 108,808 | 2.5 | 149,623 | 1.6 | 235,159 | 2.6 |
| NET EARNINGS | \$ 220,890 | 4.6 | \$ 181,424 | 4.1 | \$ 459,546 | 4.8 | \$ 393,126 | 4.4 |
| WEIGHTED AVERAGE COMMON SHARES: | | | | | | | | |
| Basic | 176,284 | | 182,868 | | 177,211 | | 184,034 | |
| Diluted | 178,200 | | 184,696 | | 178,811 | | 185,778 | |
| NET EARNINGS PER SHARE: | | | | | | | | |
| Basic | \$ 1.25 | | \$ 0.99 | | \$ 2.59 | | \$ 2.14 | |
| Diluted | \$ 1.24 | | \$ 0.98 | | \$ 2.57 | | \$ 2.12 | |

⁽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.

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

| <i>(In thousands)</i> | Three Months Ended August 31 | | Six Months Ended August 31 | |
|--|------------------------------|------------|----------------------------|------------|
| | 2018 | 2017 | 2018 | 2017 |
| NET EARNINGS | \$ 220,890 | \$ 181,424 | \$ 459,546 | \$ 393,126 |
| Other comprehensive income (loss), net of taxes | | | | |
| Net change in retirement benefit plan unrecognized actuarial losses | 370 | 275 | 739 | 549 |
| Net change in cash flow hedge unrecognized gains | 240 | (1,673) | (862) | (3,621) |
| Other comprehensive income (loss), net of taxes | 610 | (1,398) | (123) | (3,072) |
| TOTAL COMPREHENSIVE INCOME | \$ 221,500 | \$ 180,026 | \$ 459,423 | \$ 390,054 |

See accompanying notes to consolidated financial statements.

CARMAX, INC. AND SUBSIDIARIES
Consolidated Balance Sheets
(Unaudited)

| <i>(In thousands except share data)</i> | As of August 31 2018 | As of February 28 2018 |
|--|-------------------------|---------------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 37,147 | \$ 44,525 |
| Restricted cash from collections on auto loan receivables | 447,642 | 399,442 |
| Accounts receivable, net | 104,883 | 133,321 |
| Inventory | 2,357,355 | 2,390,694 |
| Other current assets | 75,060 | 93,462 |
| TOTAL CURRENT ASSETS | 3,022,087 | 3,061,444 |
| Auto loan receivables, net | 12,140,455 | 11,535,704 |
| Property and equipment, net of accumulated depreciation of \$1,230,012 and \$1,164,249 as of August 31, 2018 and February 28, 2018, respectively | 2,766,902 | 2,667,061 |
| Deferred income taxes | 56,354 | 63,256 |
| Other assets | 190,707 | 158,807 |
| TOTAL ASSETS | \$ 18,176,505 | \$ 17,486,272 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable | \$ 605,535 | \$ 529,733 |
| Accrued expenses and other current liabilities | 266,214 | 278,771 |
| Short-term debt | 3,296 | 127 |
| Current portion of finance and capital lease obligations | 10,579 | 9,994 |
| Current portion of non-recourse notes payable | 397,837 | 355,433 |
| TOTAL CURRENT LIABILITIES | 1,283,461 | 1,174,058 |
| Long-term debt, excluding current portion | 840,187 | 995,479 |
| Finance and capital lease obligations, excluding current portion | 505,167 | 490,369 |
| Non-recourse notes payable, excluding current portion | 11,831,967 | 11,266,964 |
| Other liabilities | 233,605 | 242,553 |
| TOTAL LIABILITIES | 14,694,387 | 14,169,423 |
| Commitments and contingent liabilities | | |
| SHAREHOLDERS' EQUITY: | | |
| Common stock, \$0.50 par value; 350,000,000 shares authorized; 175,289,632 and 179,747,894 shares issued and outstanding as of August 31, 2018 and February 28, 2018, respectively | 87,645 | 89,874 |
| Capital in excess of par value | 1,265,930 | 1,234,047 |
| Accumulated other comprehensive loss | (54,435) | (54,312) |
| Retained earnings | 2,182,978 | 2,047,240 |
| TOTAL SHAREHOLDERS' EQUITY | 3,482,118 | 3,316,849 |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$ 18,176,505 | \$ 17,486,272 |

See accompanying notes to consolidated financial statements.

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

| <i>(In thousands)</i> | Six Months Ended August 31 | |
|--|-----------------------------------|-------------------|
| | 2018 | 2017 |
| OPERATING ACTIVITIES: | | |
| Net earnings | \$ 459,546 | \$ 393,126 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Depreciation and amortization | 90,311 | 88,078 |
| Share-based compensation expense | 54,234 | 36,585 |
| Provision for loan losses | 70,863 | 61,465 |
| Provision for cancellation reserves | 38,699 | 34,488 |
| Deferred income tax provision | 2,539 | 2,271 |
| Other | 1,358 | 1,013 |
| Net decrease (increase) in: | | |
| Accounts receivable, net | 28,438 | 52,655 |
| Inventory | 33,339 | 28,794 |
| Other current assets | 22,161 | (1,063) |
| Auto loan receivables, net | (675,614) | (637,719) |
| Other assets | (7,167) | 83 |
| Net increase (decrease) in: | | |
| Accounts payable, accrued expenses and other current liabilities and accrued income taxes | 57,639 | 66,939 |
| Other liabilities | (65,461) | (45,618) |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | 110,885 | 81,097 |
| INVESTING ACTIVITIES: | | |
| Capital expenditures | (171,111) | (155,110) |
| Proceeds from disposal of property and equipment | 565 | 96 |
| Purchases of investments | (5,306) | (1,344) |
| Sales of investments | 904 | 370 |
| NET CASH USED IN INVESTING ACTIVITIES | (174,948) | (155,988) |
| FINANCING ACTIVITIES: | | |
| Increase in short-term debt, net | 3,169 | 209 |
| Proceeds from issuances of long-term debt | 1,300,600 | 1,552,000 |
| Payments on long-term debt | (1,456,100) | (1,689,000) |
| Cash paid for debt issuance costs | (8,189) | (7,623) |
| Payments on finance and capital lease obligations | (4,819) | (4,475) |
| Issuances of non-recourse notes payable | 5,486,502 | 4,987,000 |
| Payments on non-recourse notes payable | (4,878,974) | (4,425,923) |
| Repurchase and retirement of common stock | (381,347) | (344,785) |
| Equity issuances | 47,502 | 23,905 |
| NET CASH PROVIDED BY FINANCING ACTIVITIES | 108,344 | 91,308 |
| Increase in cash, cash equivalents and restricted cash | 44,281 | 16,417 |
| Cash, cash equivalents and restricted cash at beginning of year | 554,898 | 523,865 |
| CASH, CASH EQUIVALENTS AND RESTRICTED CASH AT END OF PERIOD | \$ 599,179 | \$ 540,282 |

RECONCILIATION OF CASH, CASH EQUIVALENTS AND RESTRICTED CASH TO THE CONSOLIDATED BALANCE SHEETS:

| | | | | |
|--|-----------|----------------|-----------|----------------|
| Cash and cash equivalents | \$ | 37,147 | \$ | 25,765 |
| Restricted cash from collections on auto loan receivables | | 447,642 | | 404,276 |
| Restricted cash included in other assets | | 114,390 | | 110,241 |
| CASH, CASH EQUIVALENTS AND RESTRICTED CASH AT END OF PERIOD | \$ | 599,179 | \$ | 540,282 |

See accompanying notes to consolidated financial statements.

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

1. Background

Business. 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.

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.

The accounting policies followed in the presentation of our interim financial results are consistent with those included in the company's Annual Report on Form 10-K for the fiscal year ended February 28, 2018 (the “2018 Annual Report”), with the exception of those related to recent accounting pronouncements adopted in the current fiscal year. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and footnotes included in our 2018 Annual Report.

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.

On March 1, 2018, we adopted Financial Accounting Standards Board (“FASB”) Accounting Standards Update (“ASU”) 2014-09 related to revenue recognition using the modified retrospective transition method for all contracts. Results for reporting periods beginning after March 1, 2018, are presented under ASU 2014-09, while comparative period amounts have not been restated and continue to be presented under the previous accounting standard. See Note 2 for further details.

In connection with our adoption of FASB ASU 2016-18 during the current fiscal year, restricted cash is now included with cash and cash equivalents in the reconciliation of beginning of year and end of period total amounts in the consolidated statements of cash flows. Prior period amounts have been reclassified to conform to the current period's presentation, resulting in a decrease in cash used by investing activities of \$29.1 million for the six months ended August 31, 2017.

Recent Accounting Pronouncements.

Effective in Future Periods.

In February 2016, the FASB issued an accounting pronouncement (FASB ASU 2016-02) related to the accounting for leases. This pronouncement, along with subsequent ASUs issued to clarify certain provisions of ASU 2016-02, 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 plan to adopt the new standard for our fiscal year beginning March 1, 2019, using the modified retrospective transition approach;

specifically, using the optional transition method provided by the accounting pronouncement (FASB ASU 2018-11), which allows for transition through a cumulative-effect adjustment at the beginning of the period of adoption.

We expect to record a \$400 million to \$430 million increase in both assets and liabilities on our opening consolidated balance sheets as a result of recognizing new right-of-use assets and lease liabilities as of March 1, 2019. This estimate is based on our lease portfolio as of February 28, 2018, and it does not include the potential impacts of remeasurement due to changes in our assessment of the lease term subsequent to our adoption of the standard. The ultimate impact of adopting this pronouncement will depend on our lease portfolio and other factors as of the transition date. We do not expect this standard to have a material impact on our sale-leaseback transactions currently accounted for as direct financings, and we believe most 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 June 2016, the FASB issued an accounting pronouncement (FASB ASU 2016-13) related to the measurement of credit losses on financial instruments. The pronouncement changes the impairment model for most financial assets and will require the use of an “expected loss” model for instruments measured at amortized cost. Under this model, entities will be required to estimate the lifetime expected credit loss on such instruments and record an allowance to offset the amortized cost basis of the financial asset, resulting in a net presentation of the amount expected to be collected on the financial asset. This pronouncement is effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2019. We plan to adopt this pronouncement for our fiscal year beginning March 1, 2020. We are currently evaluating the effect on our consolidated financial statements, as well as the impacts on our business processes, systems and internal controls, and expect that the standard will have a material impact on our calculation of the allowance for loan losses.

In August 2018, the FASB issued an accounting pronouncement (FASB ASU 2018-13) related to disclosure requirements for fair value measurements. The pronouncement eliminates, modifies and adds disclosure requirements for fair value measurements. The pronouncement is effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2019, with early adoption permitted. We are currently in the process of evaluating the effects of this pronouncement on our consolidated financial statements, including potential early adoption.

In August 2018, the FASB issued an accounting pronouncement (FASB ASU 2018-14) related to disclosure requirements for defined benefit plans. The pronouncement eliminates, modifies and adds disclosure requirements for defined benefit plans. The pronouncement is effective for fiscal years ending after December 15, 2020, and early adoption is permitted. We are currently in the process of evaluating the effects of this pronouncement on our consolidated financial statements, including potential early adoption.

In August 2018, the FASB issued an accounting pronouncement (FASB ASU 2018-15) related to customers’ accounting for implementation costs incurred in a cloud computing arrangement that is considered a service contract. This pronouncement aligns the requirements for capitalizing implementation costs in such arrangements with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. This pronouncement is effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2019. Early adoption is permitted, including adoption in any interim period for which financial statements have not been issued. Entities can choose to adopt the new guidance prospectively or retrospectively. We are currently in the process of evaluating the effects of this pronouncement on our consolidated financial statements, including potential early adoption.

2. Revenue

We recognize revenue when control of the good or service has been transferred to the customer, generally either at the time of sale or upon delivery to a customer. Our contracts have a fixed contract price and revenue is measured as the amount of consideration we expect to receive in exchange for transferring goods or providing services. 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. We generally expense sales commissions when incurred because the amortization period would have been less than one year. These costs are recorded within selling, general and administrative expenses. We do not have any significant payment terms as payment is received at or shortly after the point of sale.

On March 1, 2018, we adopted FASB ASU 2014-09 related to revenue recognition using the modified retrospective transition method for all contracts. In connection with the adoption of this standard, we recorded a net after-tax cumulative-effect adjustment to increase beginning retained earnings by \$12.9 million to recognize profit-sharing revenues on ESP contracts sold on or before February 28, 2018, with corresponding adjustments to other assets and deferred income taxes. The adoption also resulted in \$4.4 million and \$8.4 million recorded in other sales and revenues on our consolidated statement of earnings for the three and six

months ended August 31, 2018, respectively, relating to additional profit-sharing revenues to which we expect to be entitled. Lastly, the adoption resulted in a \$14.1 million increase to other current assets and accrued expenses and other current liabilities as of August 31, 2018 related to estimated vehicle sales returns, which were previously shown on a net basis.

Disaggregation of Revenue

| <i>(In millions)</i> | Three Months Ended August 31 | | Six Months Ended August 31 | |
|--|------------------------------|------------|----------------------------|------------|
| | 2018 | 2017 | 2018 | 2017 |
| Used vehicle sales | \$ 3,975.4 | \$ 3,694.2 | \$ 7,996.4 | \$ 7,537.6 |
| Wholesale vehicle sales | 628.0 | 547.8 | 1,245.6 | 1,101.2 |
| Other sales and revenues: | | | | |
| Extended protection plan revenues | 98.5 | 85.5 | 198.6 | 177.4 |
| Third-party finance fees, net | (9.7) | (11.6) | (24.2) | (23.0) |
| Service revenues | 36.1 | 34.5 | 72.7 | 68.2 |
| Other | 37.8 | 36.3 | 69.5 | 67.6 |
| Total other sales and revenues | 162.7 | 144.7 | 316.6 | 290.2 |
| Total net sales and operating revenues | \$ 4,766.0 | \$ 4,386.6 | \$ 9,558.6 | \$ 8,929.0 |

Used Vehicle Sales. We sell used vehicles at our retail stores, and revenue from the sale of these vehicles is recognized upon transfer of control of the vehicle to the 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. The reserve for estimated returns is presented gross on the consolidated balance sheets, with a return asset recorded in other current assets and a refund liability recorded in accrued expenses and other current liabilities. We also guarantee the used vehicles we sell with at least a 30-day limited warranty. These warranties are deemed assurance-type warranties and accounted for as warranty obligations. See Note 14 for additional information on this warranty and its related obligation.

Wholesale Vehicle Sales. Wholesale vehicles are sold at our auctions, and revenue from the sale of these vehicles is recognized upon transfer of control of the vehicle to the customer. Dealers also pay a fee to us based on the sale price of the vehicles they purchase. This fee is recognized as revenue at the time of sale. While we provide condition disclosures on each wholesale vehicle sold, the vehicles are subject to a limited right of return. We record a reserve for estimated returns based on historical experience and trends. The reserve for estimated returns is presented gross on the consolidated balance sheets, with a return asset recorded in other current assets and a refund liability recorded in accrued expenses and other current liabilities.

EPP Revenues. We also sell ESP and GAP products on behalf of unrelated third parties, who are primarily responsible for fulfilling the contract, 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. 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.

We are contractually entitled to receive profit-sharing revenues based on the performance of the ESPs administered by third parties. These revenues are a form of variable consideration included in the ESP transaction price to the extent that it is probable that it will not result in a significant revenue reversal. An estimate of the amount to which we expect to be entitled, subject to various constraints, is recognized upon satisfying the performance obligation of selling the ESP. These constraints include factors that are outside of the company's influence or control and the length of time until settlement. We apply the expected value method, utilizing historical claims and cancellation data from CarMax customers, as well as other qualitative assumptions. This estimate is reassessed each reporting period with changes reflected in other sales and revenues on our consolidated statements of earnings and other assets on our consolidated balance sheets. Profit-sharing payments by the ESP provider begin when the underlying ESPs reach a specified level of claims history. As of August 31, 2018, we have recognized a long-term contract asset of \$25.7 million related to cumulative profit-sharing payments to which we expect to be entitled, which is included in other assets on our consolidated balance sheets.

Third-Party Finance Fees. 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.

Service Revenues. Service revenue consists of labor and parts income related to vehicle repair service, including repairs of vehicles covered under an ESP we sell or warranty program. Service revenue is recognized at the time the work is completed.

Other Revenues. Other revenues consist primarily of new vehicle sales at our two new car franchise locations and sales of accessories. Revenue in this category is recognized upon transfer of control to the customer.

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. 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

| <i>(In millions)</i> | Three Months Ended August 31 | | | | Six Months Ended August 31 | | | |
|---|------------------------------|------------------|-------------|------------------|----------------------------|------------------|-------------|------------------|
| | 2018 | % ⁽¹⁾ | 2017 | % ⁽¹⁾ | 2018 | % ⁽¹⁾ | 2017 | % ⁽¹⁾ |
| Interest margin: | | | | | | | | |
| Interest and fee income | \$ 242.2 | 8.0 | \$ 213.6 | 7.7 | \$ 474.5 | 8.0 | \$ 420.3 | 7.7 |
| Interest expense | (69.1) | (2.3) | (52.2) | (1.9) | (132.9) | (2.2) | (101.2) | (1.8) |
| Total interest margin | 173.1 | 5.7 | 161.4 | 5.8 | 341.6 | 5.7 | 319.1 | 5.8 |
| Provision for loan losses | (40.0) | (1.3) | (32.9) | (1.2) | (70.9) | (1.2) | (61.5) | (1.1) |
| Total interest margin after provision for loan losses | 133.1 | 4.4 | 128.5 | 4.6 | 270.7 | 4.5 | 257.6 | 4.7 |
| Total other expense | (0.3) | — | — | — | (0.3) | — | — | — |
| Direct expenses: | | | | | | | | |
| Payroll and fringe benefit expense | (9.6) | (0.3) | (8.8) | (0.3) | (19.2) | (0.3) | (17.3) | (0.3) |
| Other direct expenses | (13.5) | (0.4) | (11.8) | (0.4) | (25.9) | (0.4) | (23.0) | (0.4) |
| Total direct expenses | (23.1) | (0.8) | (20.6) | (0.7) | (45.1) | (0.8) | (40.3) | (0.7) |
| CarMax Auto Finance income | \$ 109.7 | 3.6 | \$ 107.9 | 3.9 | \$ 225.3 | 3.8 | \$ 217.3 | 4.0 |
| Total average managed receivables | \$ 12,067.5 | | \$ 11,112.0 | | \$ 11,921.4 | | \$ 10,970.8 | |

⁽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 an asset-backed term funding transaction, such as a term securitization or alternative funding arrangement. We recognize transfers of auto loan receivables into the warehouse facilities and asset-backed term funding transactions (together, “non-recourse 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. The majority of the auto loan receivables serve as collateral for the related non-recourse notes payable of \$12.25 billion as of August 31, 2018 and \$11.64 billion as of February 28, 2018. See Note 9 for additional information on non-recourse notes payable.

Auto Loan Receivables, Net

| <i>(In millions)</i> | As of August 31 | | As of February 28 | |
|--|-----------------|----------|-------------------|----------|
| | 2018 | | 2018 | |
| Asset-backed term funding | \$ | 9,748.3 | \$ | 9,455.2 |
| Warehouse facilities | | 2,106.0 | | 1,834.0 |
| Overcollateralization ⁽¹⁾ | | 284.5 | | 269.4 |
| Other managed receivables ⁽²⁾ | | 75.3 | | 60.3 |
| Total ending managed receivables | | 12,214.1 | | 11,618.9 |
| Accrued interest and fees | | 51.6 | | 43.2 |
| Other | | 12.9 | | 2.2 |
| Less allowance for loan losses | | (138.1) | | (128.6) |
| Auto loan receivables, net | \$ | 12,140.5 | \$ | 11,535.7 |

⁽¹⁾ Represents receivables restricted as excess collateral for the non-recourse funding vehicles.

⁽²⁾ Other managed receivables includes receivables not funded through the non-recourse funding vehicles.

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

| <i>(In millions)</i> | As of August 31 | | As of February 28 | |
|----------------------------------|---------------------|------------------|---------------------|------------------|
| | 2018 ⁽¹⁾ | % ⁽²⁾ | 2018 ⁽¹⁾ | % ⁽²⁾ |
| A | \$ 6,031.2 | 49.4 | \$ 5,725.1 | 49.3 |
| B | 4,376.9 | 35.8 | 4,133.8 | 35.6 |
| C and other | 1,806.0 | 14.8 | 1,760.0 | 15.1 |
| Total ending managed receivables | \$ 12,214.1 | 100.0 | \$ 11,618.9 | 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

| <i>(In millions)</i> | Three Months Ended August 31 | | | | Six Months Ended August 31 | | | |
|-----------------------------------|------------------------------|------------------|----------|------------------|----------------------------|------------------|----------|------------------|
| | 2018 | % ⁽¹⁾ | 2017 | % ⁽¹⁾ | 2018 | % ⁽¹⁾ | 2017 | % ⁽¹⁾ |
| Balance as of beginning of period | \$ 134.3 | 1.13 | \$ 129.8 | 1.18 | \$ 128.6 | 1.11 | \$ 123.6 | 1.16 |
| Charge-offs | (64.9) | | (60.4) | | (123.8) | | (114.5) | |
| Recoveries | 28.7 | | 27.2 | | 62.4 | | 58.9 | |
| Provision for loan losses | 40.0 | | 32.9 | | 70.9 | | 61.5 | |
| Balance as of end of period | \$ 138.1 | 1.13 | \$ 129.5 | 1.15 | \$ 138.1 | 1.13 | \$ 129.5 | 1.15 |

⁽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 composition of the portfolio of managed 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

| <i>(In millions)</i> | As of August 31 | | As of February 28 | |
|----------------------------------|-----------------|------------------|-------------------|------------------|
| | 2018 | % ⁽¹⁾ | 2018 | % ⁽¹⁾ |
| Total ending managed receivables | \$ 12,214.1 | 100.0 | \$ 11,618.9 | 100.0 |
| Delinquent loans: | | | | |
| 31-60 days past due | \$ 262.8 | 2.1 | \$ 246.6 | 2.1 |
| 61-90 days past due | 124.4 | 1.0 | 116.9 | 1.0 |
| Greater than 90 days past due | 31.8 | 0.3 | 29.7 | 0.3 |
| Total past due | \$ 419.0 | 3.4 | \$ 393.2 | 3.4 |

⁽¹⁾ Percent of total ending managed receivables.

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.

For the derivatives associated with our non-recourse funding vehicles, 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 \$6.6 million will be reclassified in AOCL as an increase to CAF income.

As of August 31, 2018 and February 28, 2018, we had interest rate swaps outstanding with a combined notional amount of \$2.37 billion and \$2.16 billion, respectively, that were designated as cash flow hedges of interest rate risk.

See Note 6 for discussion of fair values of financial instruments and Note 12 for the effect on comprehensive income.

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 and 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 equity investments in large-, mid- and small-cap domestic and international companies or investment grade debt securities. 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, other 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

| <i>(In thousands)</i> | As of August 31, 2018 | | |
|--|-----------------------|-------------------|-------------------|
| | Level 1 | Level 2 | Total |
| Assets: | | | |
| Money market securities | \$ 343,551 | \$ — | \$ 343,551 |
| Mutual fund investments | 20,552 | — | 20,552 |
| Derivative instruments | — | 3,988 | 3,988 |
| Total assets at fair value | \$ 364,103 | \$ 3,988 | \$ 368,091 |
| Percent of total assets at fair value | 98.9% | 1.1 % | 100.0 % |
| Percent of total assets | 2.0% | — % | 2.0 % |
| Liabilities: | | | |
| Derivative instruments | \$ — | \$ (1,275) | \$ (1,275) |
| Total liabilities at fair value | \$ — | \$ (1,275) | \$ (1,275) |
| Percent of total liabilities | —% | — % | — % |

| <i>(In thousands)</i> | As of February 28, 2018 | | |
|--|-------------------------|------------------|-------------------|
| | Level 1 | Level 2 | Total |
| Assets: | | | |
| Money market securities | \$ 276,894 | \$ — | \$ 276,894 |
| Mutual fund investments | 19,429 | — | 19,429 |
| Derivative instruments | — | 12,127 | 12,127 |
| Total assets at fair value | \$ 296,323 | \$ 12,127 | \$ 308,450 |
| Percent of total assets at fair value | 96.1% | 3.9% | 100.0% |
| Percent of total assets | 1.7% | 0.1% | 1.8% |
| Liabilities: | | | |
| Derivative instruments | \$ — | \$ (99) | \$ (99) |
| Total liabilities at fair value | \$ — | \$ (99) | \$ (99) |
| Percent of total liabilities | —% | — % | — % |

There were no transfers between Levels 1 and 2 for the three and six months ended August 31, 2018. As of August 31, 2018 and February 28, 2018, 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 August 31, 2018 and February 28, 2018, respectively, are as follows:

| <i>(In thousands)</i> | As of August 31, 2018 | | As of February 28, 2018 | |
|-----------------------|-----------------------|---------|-------------------------|---------|
| Carrying value | \$ | 500,000 | \$ | 500,000 |
| Fair value | \$ | 486,149 | \$ | 492,163 |

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

| <i>(In millions)</i> | Three Months Ended August 31 | | Six Months Ended August 31 | |
|------------------------------------|------------------------------|----------|----------------------------|----------|
| | 2018 | 2017 | 2018 | 2017 |
| Balance as of beginning of period | \$ 108.7 | \$ 109.0 | \$ 105.2 | \$ 108.2 |
| Cancellations | (16.7) | (16.6) | (33.3) | (32.9) |
| Provision for future cancellations | 18.6 | 17.4 | 38.7 | 34.5 |
| Balance as of end of period | \$ 110.6 | \$ 109.8 | \$ 110.6 | \$ 109.8 |

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 August 31, 2018 and February 28, 2018, the current portion of cancellation reserves was \$58.3 million and \$56.0 million, respectively.

8. Income Taxes

The Tax Cuts and Jobs Act of 2017 (the “2017 Tax Act”) was enacted on December 22, 2017, and, among other changes, reduced the federal statutory tax rate from 35.0% to 21.0%. In accordance with U.S. GAAP for income taxes, as well as SEC Staff Accounting Bulletin No. 118 (“SAB 118”), the company made a reasonable estimate of the impacts of the 2017 Tax Act and recorded this estimate in its results for the year ended February 28, 2018. The company will continue to evaluate the impacts as additional clarification and implementation guidance related to the 2017 Tax Act is released. SAB 118 allows for a measurement period of up to one year, from the date of enactment, to complete the company’s accounting for the impacts of the 2017 Tax Act. As of August 31, 2018, no additional adjustments have been made to the provisional amounts recorded as of February 28, 2018.

The company’s income tax provision for the six months ended August 31, 2018, includes estimates related to its interpretation of the 2017 Tax Act. These estimates may change as additional clarification and implementation guidance is released.

We had \$30.1 million of gross unrecognized tax benefits as of August 31, 2018, and \$28.7 million as of February 28, 2018. There were no significant changes to the gross unrecognized tax benefits as reported for the year ended February 28, 2018.

9. Debt

| <i>(In thousands)</i> | As of August 31 | As of February 28 |
|---------------------------------------|-----------------|-------------------|
| | 2018 | 2018 |
| Revolving credit facility | \$ 45,296 | \$ 197,627 |
| 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 | 515,746 | 500,363 |
| Non-recourse notes payable | 12,252,143 | 11,644,615 |
| Total debt | 13,613,185 | 13,142,605 |
| Less: current portion | (411,712) | (365,554) |
| Less: unamortized debt issuance costs | (24,152) | (24,239) |
| Long-term debt, net | \$ 13,177,321 | \$ 12,752,812 |

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 as no repayments are expected to be made within the next 12 months. As of August 31, 2018, the unused capacity of \$1.15 billion was fully available to us.

Term Loan. We have a \$300 million unsecured 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 August 31, 2018, \$300 million remained outstanding and is 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.

Senior Notes. We have senior unsecured notes with outstanding principal totaling \$500 million as of August 31, 2018, which are due in 2023, 2026 and 2028. These notes are 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 direct 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 13 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 non-recourse funding vehicles. 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 August 31, 2018, \$10.15 billion of non-recourse notes payable was outstanding related to asset-backed term funding transactions. These notes payable accrue interest predominantly at fixed rates and have scheduled maturities through April 2025, but may mature earlier, depending upon the repayment rate of the underlying auto loan receivables.

As of August 31, 2018, \$2.11 billion of non-recourse notes payable was outstanding related to our warehouse facilities. As of August 31, 2018, the combined limit of our warehouse facilities was \$3.14 billion, and the unused warehouse capacity totaled \$1.03 billion. Of the combined limit, \$1.70 billion will expire in February 2019 and \$1.30 billion will expire in August 2019. Subsequent to the end of the quarter, the limit on the remaining \$140 million facility was increased to \$150 million and the expiration date was extended from September 2018 to September 2019. 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 Note 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 six months ended August 31, 2018 and 2017, we capitalized interest of \$3.1 million and \$3.7 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. The agreements governing our non-recourse funding vehicles contain representations and warranties, financial covenants and performance triggers. As of August 31, 2018, we were in compliance with all financial covenants and our non-recourse funding vehicles were in compliance with the related performance triggers.

10. Stock and Stock-Based Incentive Plans

(A) Share Repurchase Program

As of August 31, 2018, a total of \$750 million of board authorizations for repurchases of our common stock were outstanding, with no expiration date. At that date, \$638.3 million remained available for repurchase.

Common Stock Repurchases

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|------------|------------------|------------|
| | August 31 | | August 31 | |
| | 2018 | 2017 | 2018 | 2017 |
| Number of shares repurchased <i>(in thousands)</i> | 2,291.7 | 2,453.1 | 5,599.3 | 5,487.8 |
| Average cost per share | \$ 74.70 | \$ 63.78 | \$ 67.61 | \$ 61.69 |
| Available for repurchase, as of end of period <i>(in millions)</i> | \$ 638.3 | \$ 1,251.8 | \$ 638.3 | \$ 1,251.8 |

(B) Share-Based Compensation

Composition of Share-Based Compensation Expense

| <i>(In thousands)</i> | Three Months Ended | | Six Months Ended | |
|---|--------------------|-----------|------------------|-----------|
| | August 31 | | August 31 | |
| | 2018 | 2017 | 2018 | 2017 |
| Cost of sales | \$ 1,603 | \$ 1,076 | \$ 2,894 | \$ 1,303 |
| CarMax Auto Finance income | 1,237 | 848 | 2,434 | 1,668 |
| Selling, general and administrative expenses | 22,775 | 16,316 | 49,752 | 34,409 |
| Share-based compensation expense, before income taxes | \$ 25,615 | \$ 18,240 | \$ 55,080 | \$ 37,380 |

Composition of Share-Based Compensation Expense – By Grant Type

| <i>(In thousands)</i> | Three Months Ended | | Six Months Ended | |
|---|--------------------|-----------|------------------|-----------|
| | August 31 | | August 31 | |
| | 2018 | 2017 | 2018 | 2017 |
| Nonqualified stock options | \$ 6,493 | \$ 5,916 | \$ 17,608 | \$ 16,286 |
| Cash-settled restricted stock units (RSUs) | 15,540 | 9,785 | 27,894 | 12,903 |
| Stock-settled market stock units (MSUs) | 2,643 | 2,543 | 7,279 | 6,164 |
| Other share-based incentives: | | | | |
| Stock-settled performance stock units (PSUs) | 320 | (863) | 726 | 490 |
| Restricted stock (RSAs) | (54) | 478 | 433 | 742 |
| Stock-settled deferred stock units (DSUs) | 294 | — | 294 | — |
| Employee stock purchase plan | 379 | 381 | 846 | 795 |
| Total other share-based incentives | \$ 939 | \$ (4) | \$ 2,299 | \$ 2,027 |
| Share-based compensation expense, before income taxes | \$ 25,615 | \$ 18,240 | \$ 55,080 | \$ 37,380 |

(C) Stock Incentive Plan Information

Share/Unit Activity

| <i>(Shares/units in thousands)</i> | Six Months Ended August 31, 2018 | | | |
|-------------------------------------|----------------------------------|------|-------|----------------------|
| | Equity Classified | | | Liability Classified |
| | Options | MSUs | Other | RSUs |
| Outstanding as of February 28, 2018 | 7,762 | 419 | 271 | 1,460 |
| Granted | 1,738 | 204 | 23 | 629 |
| Exercised or vested and converted | (1,072) | (94) | (93) | (339) |
| Cancelled | (256) | (15) | (39) | (74) |
| Outstanding as of August 31, 2018 | 8,172 | 514 | 162 | 1,676 |

Weighted average grant date fair value per share/unit:

| | | | | | | | | |
|--------------------|----|-------|----|-------|----|-------|----|-------|
| Granted | \$ | 18.74 | \$ | 81.99 | \$ | 73.22 | \$ | 63.06 |
| Ending outstanding | \$ | 16.51 | \$ | 74.25 | \$ | 57.45 | \$ | 58.01 |

| | As of August 31, 2018 | | | | | | |
|--|-----------------------|------|----|------|----|-----|--|
| Unrecognized compensation <i>(in millions)</i> | \$ | 49.8 | \$ | 18.2 | \$ | 3.0 | |

11. 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

| <i>(In thousands except per share data)</i> | Three Months Ended | | Six Months Ended | |
|---|--------------------|------------|------------------|------------|
| | August 31 | | August 31 | |
| | 2018 | 2017 | 2018 | 2017 |
| Net earnings | \$ 220,890 | \$ 181,424 | \$ 459,546 | \$ 393,126 |
| Weighted average common shares outstanding | 176,284 | 182,868 | 177,211 | 184,034 |
| Dilutive potential common shares: | | | | |
| Stock options | 1,462 | 1,465 | 1,194 | 1,337 |
| Stock-settled stock units and awards | 454 | 363 | 406 | 407 |
| Weighted average common shares and dilutive potential common shares | 178,200 | 184,696 | 178,811 | 185,778 |
| Basic net earnings per share | \$ 1.25 | \$ 0.99 | \$ 2.59 | \$ 2.14 |
| Diluted net earnings per share | \$ 1.24 | \$ 0.98 | \$ 2.57 | \$ 2.12 |

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 August 31, 2018 and 2017, options to purchase 2,210,917 shares and 3,130,285 shares of common stock, respectively, were not included. For the six months ended August 31, 2018 and 2017, options to purchase 3,805,873 shares and 2,854,557 shares of common stock, respectively, were not included.

12. Accumulated Other Comprehensive Loss

Changes in Accumulated Other Comprehensive Loss By Component

| | Net Unrecognized Actuarial Losses | | Net Unrecognized Hedge Gains | | Total Accumulated Other Comprehensive Loss |
|--|--|-----------------|------------------------------------|---------------|--|
| <i>(In thousands, net of income taxes)</i> | | | | | |
| Balance as of February 28, 2018 | \$ | (68,497) | \$ | 14,185 | \$ (54,312) |
| Other comprehensive income before reclassifications | | — | | 1,325 | 1,325 |
| Amounts reclassified from accumulated other comprehensive loss | | 739 | | (2,187) | (1,448) |
| Other comprehensive income (loss) | | 739 | | (862) | (123) |
| Balance as of August 31, 2018 | \$ | (67,758) | \$ | 13,323 | \$ (54,435) |

Changes In and Reclassifications Out of Accumulated Other Comprehensive Loss

| | Three Months Ended August 31 | | Six Months Ended August 31 | |
|--|------------------------------|------------|----------------------------|------------|
| | 2018 | 2017 | 2018 | 2017 |
| <i>(In thousands)</i> | | | | |
| Retirement Benefit Plans: | | | | |
| Actuarial loss amortization reclassifications recognized in net pension expense: | | | | |
| Cost of sales | \$ 204 | \$ 187 | \$ 405 | \$ 372 |
| CarMax Auto Finance income | 12 | 11 | 25 | 22 |
| Selling, general and administrative expenses | 271 | 255 | 544 | 513 |
| Total amortization reclassifications recognized in net pension expense | 487 | 453 | 974 | 907 |
| Tax expense | (117) | (178) | (235) | (358) |
| Amortization reclassifications recognized in net pension expense, net of tax | 370 | 275 | 739 | 549 |
| Net change in retirement benefit plan unrecognized actuarial losses, net of tax | 370 | 275 | 739 | 549 |
| Cash Flow Hedges (Note 5): | | | | |
| Effective portion of changes in fair value | 2,187 | (3,712) | 1,800 | (7,938) |
| Tax (expense) benefit | (577) | 1,461 | (475) | 3,125 |
| Effective portion of changes in fair value, net of tax | 1,610 | (2,251) | 1,325 | (4,813) |
| Reclassifications to CarMax Auto Finance income | (1,861) | 952 | (2,970) | 1,965 |
| Tax benefit (expense) | 491 | (374) | 783 | (773) |
| Reclassification of hedge (gains) losses, net of tax | (1,370) | 578 | (2,187) | 1,192 |
| Net change in cash flow hedge unrecognized gains, net of tax | 240 | (1,673) | (862) | (3,621) |
| Total other comprehensive income (loss), net of tax | \$ 610 | \$ (1,398) | \$ (123) | \$ (3,072) |

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 \$16.6 million as of August 31, 2018 and February 28, 2018.

13. Supplemental Cash Flow Information

Supplemental disclosures of cash flow information:

| <i>(In thousands)</i> | Six Months Ended August 31 | |
|---|----------------------------|------------|
| | 2018 | 2017 |
| Non-cash investing and financing activities: | | |
| Decrease in accrued capital expenditures | \$ (5,509) | \$ (2,864) |
| Increase in finance and capital lease obligations | \$ 19,605 | \$ 10,245 |

14. Contingent Liabilities

Litigation. CarMax entities are defendants in four 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. On October 31, 2017, Joshua Sabanovich v. CarMax Superstores California, LLC et. al., a putative class action, was filed in the Superior Court of California, County of Stanislaus. The Sabanovich 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. 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 \$7.3 million as of August 31, 2018, and \$6.1 million as of February 28, 2018, 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, 2018 ("fiscal 2018"), 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 August 31, 2018, we operated 194 used car stores in 93 U.S. television markets. As of that date, we also conducted wholesale auctions at 75 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 43.4% of our retail used vehicle unit sales in the first six months of fiscal 2019. As of August 31, 2018, CAF serviced approximately 938,000 customer accounts in its \$12.21 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 and Six Months Ended August 31, 2018

During the second quarter of fiscal 2019, net sales and operating revenues increased 8.6% and net earnings increased 21.8%. The increase in net earnings was due to a decrease in the effective income tax rate to 23.7% in the second quarter of fiscal 2019 from 37.5% in the second quarter of fiscal 2018, primarily reflecting the effect of the Tax Cuts and Jobs Act of 2017 (the "2017 Tax Act"). The 26.5% increase in net 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 earnings is the retail sale of used vehicles. During the second quarter of fiscal 2019, we sold 196,880 used vehicles, representing 83.4% of our net sales and operating revenues and 65.9% of our gross profit. Compared

with the prior year period, used vehicle revenues grew 7.6% and used vehicle gross profits improved 5.9%. Total used unit sales increased 5.8%, which included a 2.1% increase in comparable store used units.

Wholesale sales are also a significant contributor to our revenues and net earnings. During the second quarter of fiscal 2019, we sold 120,866 wholesale vehicles, representing 13.2% of our net sales and operating revenues and 17.1% of our gross profit. Compared with the prior year period, wholesale vehicle revenues grew 14.6% and wholesale vehicle gross profits increased 10.8%, primarily due to a 14.6% increase in unit sales.

During the second quarter of fiscal 2019, other sales and revenues, which include revenues earned on the sale of EPP products, net third-party finance fees and service department and new vehicle sales, represented 3.4% of our net sales and operating revenues and 17.0% of our gross profit. Compared with the prior year period, other sales and revenues increased 12.4% and other gross profit rose 12.2%, primarily reflecting improvements in EPP revenues.

Income from our CAF segment totaled \$109.7 million in the second quarter of fiscal 2019, up 1.6% compared with the prior year period. The increase in CAF income reflected the net effects of an increase in average managed receivables, an increase in the provision for loan losses and a slightly lower total interest margin percentage.

Selling, general and administrative (“SG&A”) expenses increased 12.0% to \$453.6 million, primarily reflecting the 10% increase in our store base since the beginning of the second quarter of fiscal 2018, as well as increases in advertising expense, share-based compensation expense and spending on strategic initiatives.

The effective income tax rate declined to 23.7% in the second quarter of fiscal 2019 from 37.5% in the second quarter of fiscal 2018, primarily due to the reduction in the federal statutory tax rate following the enactment of the 2017 Tax Act.

During the first half of fiscal 2019, net sales and operating revenues increased 7.1%, net earnings increased 16.9% and net earnings per share increased 21.2%.

Liquidity

Our primary ongoing sources of liquidity include funds provided by operations, proceeds from non-recourse funding vehicles, and borrowings under our revolving credit facility or through other financing sources. During the first six months of fiscal 2019, net cash provided by operations totaled \$110.9 million. This amount, combined with \$607.5 million of net issuances of non-recourse notes payable, resulted in \$718.4 million of adjusted net cash provided by operating activities (a non-GAAP measure). This liquidity was primarily used to fund the 5.6 million common shares repurchased under our share repurchase program, our store growth and the reduction of our outstanding revolving credit borrowings.

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

Our long-term strategy is to complete the rollout of our retail concept and to increase our share of used vehicle unit sales in each of the markets in which we operate. We believe that, over the long term, used vehicle unit sales are the primary driver for earnings growth. 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.

As of August 31, 2018, we had used car stores located in 93 U.S. television markets, which covered approximately 74% of the U.S. population. Completing our rollout requires a disciplined approach to opening stores in new markets and expanding our presence in existing markets. The format and operating models utilized in stores are continuously evaluated and may change or evolve over time based upon market and consumer expectations. During the first six months of fiscal 2019, we opened 6 stores, and during the remainder of the fiscal year, we plan to open 9 stores. In fiscal 2020, we plan to open between 13 and 16 stores. For a detailed list of stores we plan to open in the 12 months following August 31, 2018, see the table included in “PLANNED FUTURE ACTIVITIES.”

In calendar 2017, we estimate we sold approximately 4.6% of the age 0- to 10-year old vehicles sold in the television markets in which we operate. Our strategy to increase our share of each of these markets includes focusing on:

- Delivering an unrivaled customer experience both in stores and online.
- Connecting the digital and physical customer experiences to create an exceptional omni-channel buying and selling experience.
- Hiring and developing an engaged and skilled workforce.
- Improving efficiency to drive out waste.
- Leveraging data and advanced analytics to continuously improve our processes and systems.

We are investing in various strategic initiatives to increase innovation, specifically with regards to customer facing and customer-enabling technologies. We continue to make improvements to our website and test new customer experiences, such as finance pre-approval, home delivery, online appraisal and express pick-up. Our use of data is a core component of these initiatives and continues to be a strategic asset for us as we leverage data to enhance the customer experience and increase operational efficiencies. Ultimately, our goal is to create an omni-channel experience that enables customers to seamlessly move across the online and in-store experience with ease. We plan to bring this omni-channel experience to a major market later this fiscal year, which will help us learn how to best operationalize all our offerings and scale them across the entire organization.

While we execute our long-term strategy, there are trends and factors that could impact our strategic approach or our results in the short and medium term. 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. While conditions in any one quarter may vary, this has and could continue to reduce wholesale auction prices and our vehicle acquisition costs. It could also impact CAF recovery rates.

The federal statutory tax rate associated with the 2017 Tax Act, which was enacted in our fourth quarter of fiscal 2018, is expected to continue to benefit our financial results and cash flows. We currently intend to use those benefits to invest in our associates and business, including our digital and technology capabilities. We expect that, after these investments, 70% to 85% of the benefit from the lower tax rate will impact our net earnings. 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.

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, 2018.

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, 2018.

RESULTS OF OPERATIONS – CARMAX SALES OPERATIONS

NET SALES AND OPERATING REVENUES

| <i>(In millions)</i> | Three Months Ended August 31 | | | Six Months Ended August 31 | | |
|--|------------------------------|------------|--------|----------------------------|------------|--------|
| | 2018 | 2017 | Change | 2018 | 2017 | Change |
| Used vehicle sales | \$ 3,975.4 | \$ 3,694.2 | 7.6% | \$ 7,996.4 | \$ 7,537.6 | 6.1 % |
| Wholesale vehicle sales | 628.0 | 547.8 | 14.6% | 1,245.6 | 1,101.2 | 13.1 % |
| Other sales and revenues: | | | | | | |
| Extended protection plan revenues | 98.5 | 85.5 | 15.2% | 198.6 | 177.4 | 11.9 % |
| Third-party finance fees, net | (9.7) | (11.6) | 16.3% | (24.2) | (23.0) | (5.0)% |
| Other | 73.9 | 70.8 | 4.4% | 142.2 | 135.8 | 4.7 % |
| Total other sales and revenues | 162.7 | 144.7 | 12.4% | 316.6 | 290.2 | 9.1 % |
| Total net sales and operating revenues | \$ 4,766.0 | \$ 4,386.6 | 8.6% | \$ 9,558.6 | \$ 8,929.0 | 7.1 % |

UNIT SALES

| | Three Months Ended August 31 | | | Six Months Ended August 31 | | |
|--------------------|------------------------------|---------|--------|----------------------------|---------|--------|
| | 2018 | 2017 | Change | 2018 | 2017 | Change |
| Used vehicles | 196,880 | 186,019 | 5.8% | 395,278 | 381,292 | 3.7% |
| Wholesale vehicles | 120,866 | 105,508 | 14.6% | 234,201 | 208,951 | 12.1% |

AVERAGE SELLING PRICES

| | Three Months Ended August 31 | | | Six Months Ended August 31 | | |
|--------------------|------------------------------|-----------|--------|----------------------------|-----------|--------|
| | 2018 | 2017 | Change | 2018 | 2017 | Change |
| Used vehicles | \$ 20,005 | \$ 19,667 | 1.7% | \$ 20,036 | \$ 19,570 | 2.4% |
| Wholesale vehicles | \$ 4,955 | \$ 4,957 | —% | \$ 5,076 | \$ 5,034 | 0.8% |

COMPARABLE STORE USED VEHICLE SALES CHANGES

| | Three Months Ended August 31 ⁽¹⁾ | | Six Months Ended August 31 ⁽¹⁾ | |
|-----------------------|---|------|---|------|
| | 2018 | 2017 | 2018 | 2017 |
| Used vehicle units | 2.1% | 5.3% | (0.2)% | 6.8% |
| Used vehicle revenues | 3.8% | 6.0% | 2.2 % | 6.1% |

⁽¹⁾ 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 August 31 | | Six Months Ended August 31 | |
|----------------------------|------------------------------|--------|----------------------------|--------|
| | 2018 | 2017 | 2018 | 2017 |
| Used vehicle units | 5.8% | 11.1 % | 3.7% | 12.6 % |
| Used vehicle revenues | 7.6% | 11.9 % | 6.1% | 12.0 % |
| Wholesale vehicle units | 14.6% | 0.4 % | 12.1% | 0.2 % |
| Wholesale vehicle revenues | 14.6% | (2.3)% | 13.1% | (2.4)% |

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

| | Three Months Ended August 31 ⁽¹⁾ | | Six Months Ended August 31 ⁽¹⁾ | |
|-----------------------|---|--------|---|--------|
| | 2018 | 2017 | 2018 | 2017 |
| CAF ⁽²⁾ | 49.3% | 49.0% | 48.8% | 48.1% |
| Tier 2 ⁽³⁾ | 17.0% | 16.0% | 17.0% | 17.6% |
| Tier 3 ⁽⁴⁾ | 8.8% | 9.6% | 9.9% | 9.8% |
| Other ⁽⁵⁾ | 24.9% | 25.4% | 24.3% | 24.5% |
| Total | 100.0% | 100.0% | 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 August 31 | | Six Months Ended August 31 | |
|--------------------------------------|------------------------------|------|----------------------------|------|
| | 2018 | 2017 | 2018 | 2017 |
| Used car stores, beginning of period | 191 | 176 | 188 | 173 |
| Store openings | 3 | 3 | 6 | 6 |
| Used car stores, end of period | 194 | 179 | 194 | 179 |

During the first six months of fiscal 2019, we opened six stores, including two stores in new television markets (one store each in Greenville, NC and Macon, GA) and four stores in existing television markets (one store each in Dallas, TX; Miami, FL; Albuquerque, NM; and Oklahoma City, OK).

Used Vehicle Sales. The 7.6% increase in used vehicle revenues in the second quarter of fiscal 2019 was due to a 5.8% increase in used unit sales, as well as a 1.7% increase in average retail selling price. The increase in used units included sales from newer stores not yet included in the comparable store base and the 2.1% increase in comparable store used unit sales. The comparable store used unit sales performance primarily reflected improved conversion, partially offset by lower store traffic. Website traffic grew 19%. We believe that solid performance of our store teams and contributions from our digital initiatives contributed to our continued improvements in conversion.

The 6.1% increase in used vehicle revenues in the first half of fiscal 2019 was primarily due to a 3.7% increase in used unit sales, as well as a 2.4% increase in average retail selling price. The increase in used units included sales from newer stores not yet included in the comparable store base, partially offset by the 0.2% decrease in comparable store used unit sales. The comparable store used unit sales performance primarily reflected lower store traffic, partially offset by improved conversion. Website traffic for the first half of fiscal 2019 grew 17%.

The increase in average retail selling price reflected the net effects of higher vehicle acquisition costs and shifts in the mix of our sales by both vehicle age and class. We believe vehicle acquisition costs remained high in the second quarter and first half of fiscal 2019 as the industry continues to experience an unusual depreciation environment. This contrasts with fiscal 2018, when our vehicle acquisition costs were significantly lower year-over-year.

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 14.6% increase in wholesale vehicle revenues in the second quarter of fiscal 2019 was due to a 14.6% increase in unit sales. The wholesale unit growth was driven by an increase in appraisal traffic, the growth in our store base and a higher appraisal buy rate.

The 13.1% increase in wholesale vehicle revenues in the first half of fiscal 2019 was primarily due to a 12.1% increase in unit sales. The wholesale unit growth reflected an increase in our appraisal buy rate, the growth in our store base and an increase in appraisal traffic.

We believe the appraisal buy rate and appraisal traffic benefited from strong wholesale industry vehicle valuations, which allowed us to provide seasonally strong appraisal offers.

Other Sales and Revenues. Other sales and revenues include revenue from the sale of ESPs and GAP (collectively reported in EPP revenues), net third-party finance fees, and other revenues, which are predominantly comprised of service department and new vehicle sales. EPP revenues are recognized on a net basis and include a reserve for estimated contract cancellations. 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 12.4% in the second quarter of fiscal 2019. EPP revenues increased 15.2%, reflecting the increase in our retail unit volume and cost decreases from plan providers, as well as a \$4.4 million benefit associated with the accelerated recognition of revenue related to ESPs. The accelerated recognition resulted from our adoption of the new revenue recognition accounting standard in the first quarter of fiscal 2019. See Note 2 for additional information on revenue related to ESPs. Net third-party finance fees improved \$1.9 million, reflecting shifts in our sales mix by finance channel, including an increase in our Tier 2 and a decrease in our Tier 3 sales, partially due to tightened lending standards by one of our third-party Tier 3 finance providers.

Other sales and revenues increased 9.1% in the first half of fiscal 2019, primarily due to EPP revenues. EPP revenues increased 11.9%, reflecting cost decreases from plan providers, an \$8.4 million benefit associated with the accelerated recognition of revenue related to ESPs and the increase in our retail unit volume.

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

| <i>(In millions)</i> | Three Months Ended August 31 | | | Six Months Ended August 31 | | |
|--------------------------------|------------------------------|----------|--------|----------------------------|------------|--------|
| | 2018 | 2017 | Change | 2018 | 2017 | Change |
| Used vehicle gross profit | \$ 429.0 | \$ 405.1 | 5.9% | \$ 868.4 | \$ 837.1 | 3.7% |
| Wholesale vehicle gross profit | 111.1 | 100.3 | 10.8% | 225.8 | 204.9 | 10.2% |
| Other gross profit | 110.5 | 98.6 | 12.2% | 217.8 | 210.9 | 3.2% |
| Total | \$ 650.6 | \$ 604.0 | 7.7% | \$ 1,312.0 | \$ 1,252.9 | 4.7% |

GROSS PROFIT PER UNIT

| | Three Months Ended August 31 | | | | Six Months Ended August 31 | | | |
|--------------------------------|------------------------------|------------------|----------------------------|------------------|----------------------------|------------------|----------------------------|------------------|
| | 2018 | | 2017 | | 2018 | | 2017 | |
| | \$ per unit ⁽¹⁾ | % ⁽²⁾ | \$ per unit ⁽¹⁾ | % ⁽²⁾ | \$ per unit ⁽¹⁾ | % ⁽²⁾ | \$ per unit ⁽¹⁾ | % ⁽²⁾ |
| Used vehicle gross profit | \$ 2,179 | 10.8 | \$ 2,178 | 11.0 | \$ 2,197 | 10.9 | \$ 2,195 | 11.1 |
| Wholesale vehicle gross profit | \$ 919 | 17.7 | \$ 950 | 18.3 | \$ 964 | 18.1 | \$ 981 | 18.6 |
| Other gross profit | \$ 562 | 68.0 | \$ 530 | 68.1 | \$ 551 | 68.8 | \$ 553 | 72.7 |
| Total gross profit | \$ 3,305 | 13.7 | \$ 3,247 | 13.8 | \$ 3,319 | 13.7 | \$ 3,286 | 14.0 |

⁽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 adjust 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 the wholesale and retail vehicle pricing environments, vehicle reconditioning and logistics costs, and the percentage of vehicles sourced directly from consumers through our appraisal process. 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 5.9% in the second quarter of fiscal 2019 and 3.7% in the first half of fiscal 2019, driven by the 5.8% and 3.7% growth in total used unit sales, respectively. Our used vehicle gross profit per unit was similar to 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.

In the second quarter of fiscal 2019, wholesale vehicle gross profit increased 10.8%, driven by the 14.6% increase in wholesale unit sales, partially offset by a \$31, or 3.3%, decrease in wholesale gross profit per unit. For the first half of fiscal 2019, wholesale vehicle gross profit increased 10.2%, driven by the 12.1% increase in wholesale unit sales, partially offset by a \$17, or 1.7%, decrease in wholesale gross profit per unit.

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 12.2% in the second quarter of fiscal 2019 and 3.2% in the first half of fiscal 2019, primarily reflecting the changes in other sales and revenues discussed above, partially offset by a \$3.1 million and \$13.1 million decrease in service profits in the second quarter and first half of fiscal 2019, respectively. Service profits were affected by the reduced leverage of service department costs in both the second quarter and the first half of fiscal 2019.

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

| <i>(In millions except per unit data)</i> | Three Months Ended August 31 | | | Six Months Ended August 31 | | |
|---|------------------------------|----------|--------|----------------------------|----------|--------|
| | 2018 | 2017 | Change | 2018 | 2017 | Change |
| Compensation and benefits ⁽¹⁾ | \$ 238.9 | \$ 218.2 | 9.5% | \$ 480.3 | \$ 440.6 | 9.0% |
| Store occupancy costs | 90.8 | 85.2 | 6.6% | 178.6 | 164.9 | 8.3% |
| Advertising expense | 46.7 | 39.6 | 17.9% | 85.2 | 77.8 | 9.5% |
| Other overhead costs ⁽²⁾ | 77.2 | 62.1 | 24.3% | 147.7 | 125.3 | 17.9% |
| Total SG&A expenses | \$ 453.6 | \$ 405.1 | 12.0% | \$ 891.8 | \$ 808.6 | 10.3% |
| SG&A per used vehicle unit ⁽³⁾ | \$ 2,304 | \$ 2,178 | \$ 126 | \$ 2,256 | \$ 2,121 | \$ 135 |

⁽¹⁾ Excludes compensation and benefits related to reconditioning and vehicle repair service, which are included in cost of sales. See Note 10 for details of share-based compensation expense by grant type.

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

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

SG&A expenses increased 12.0% in the second quarter of fiscal 2019. The increase reflected the 10% growth in our store base since the beginning of last year's second quarter (representing the addition of 18 stores) and a \$6.5 million increase in share-based compensation expense. The increase in share-based compensation expense was largely related to cash-settled restricted stock units, as the expense associated with these units was primarily driven by the change in the company's stock price during the relevant periods. Advertising expense rose 17.9% largely reflecting timing shifts compared with the prior year. The increase in other overhead costs included increased spending as we continue to update our technology platforms and support our core strategic initiatives as part of our focus on improving the omni-channel customer experience.

SG&A expenses increased 10.3% in the first half of fiscal 2019. The increase primarily reflected the 12% growth in our store base since the beginning of fiscal 2018 (representing the addition of 21 stores) and a \$15.3 million increase in share-based compensation expense. The increase in other overhead costs included increased spending on strategic initiatives as noted above.

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 \$18.0 million and \$36.0 million in the second quarter and first half of fiscal 2019, respectively, from \$16.8 million and \$33.7 million in the second quarter and first half of fiscal 2018, respectively. The increase primarily reflected higher interest rates in both the second quarter and first half of fiscal 2019.

Income Taxes. The effective income tax rate was 23.7% in the second quarter of fiscal 2019 and 24.6% in the first six months of fiscal 2019 versus 37.5% in the second quarter of fiscal 2018 and 37.4% in the first half of fiscal 2018. The decrease is primarily due to the reduction in the federal statutory tax rate following the enactment of the 2017 Tax Act. The effective tax rate for both the second quarter and first half of fiscal 2019 was also reduced by share-based awards that settled during the periods.

RESULTS OF OPERATIONS – CARMAX AUTO FINANCE

CAF income primarily reflects 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

| <i>(In millions)</i> | Three Months Ended August 31 | | | | Six Months Ended August 31 | | | |
|----------------------------|------------------------------|------------------|-----------|------------------|----------------------------|------------------|-----------|------------------|
| | 2018 | % ⁽¹⁾ | 2017 | % ⁽¹⁾ | 2018 | % ⁽¹⁾ | 2017 | % ⁽¹⁾ |
| Interest margin: | | | | | | | | |
| Interest and fee income | \$ 242.2 | 8.0 | \$ 213.6 | 7.7 | \$ 474.5 | 8.0 | \$ 420.3 | 7.7 |
| Interest expense | (69.1) | (2.3) | (52.2) | (1.9) | (132.9) | (2.2) | (101.2) | (1.8) |
| Total interest margin | \$ 173.1 | 5.7 | \$ 161.4 | 5.8 | \$ 341.6 | 5.7 | \$ 319.1 | 5.8 |
| Provision for loan losses | \$ (40.0) | (1.3) | \$ (32.9) | (1.2) | \$ (70.9) | (1.2) | \$ (61.5) | (1.1) |
| CarMax Auto Finance income | \$ 109.7 | 3.6 | \$ 107.9 | 3.9 | \$ 225.3 | 3.8 | \$ 217.3 | 4.0 |

⁽¹⁾ Annualized percentage of total average managed receivables.

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

| | Three Months Ended August 31 | | Six Months Ended August 31 | |
|---|------------------------------|------------|----------------------------|------------|
| | 2018 | 2017 | 2018 | 2017 |
| Net loans originated <i>(in millions)</i> | \$ 1,678.4 | \$ 1,542.2 | \$ 3,343.9 | \$ 3,088.3 |
| Vehicle units financed | 86,399 | 80,976 | 171,496 | 162,763 |
| Net penetration rate ⁽¹⁾ | 43.9% | 43.5% | 43.4% | 42.7% |
| Weighted average contract rate | 8.5% | 7.6% | 8.4% | 7.7% |
| Weighted average credit score ⁽²⁾ | 707 | 709 | 705 | 707 |
| Weighted average loan-to-value (LTV) ⁽³⁾ | 95.2% | 95.2% | 95.1% | 95.0% |
| Weighted average term <i>(in months)</i> | 66.0 | 65.8 | 66.0 | 65.8 |

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

⁽²⁾ 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.

⁽³⁾ 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 August 31 | | As of and for the Six Months Ended August 31 | |
|---|--|-------------|--|-------------|
| | 2018 | 2017 | 2018 | 2017 |
| Total ending managed receivables | \$ 12,214.1 | \$ 11,252.8 | \$ 12,214.1 | \$ 11,252.8 |
| Total average managed receivables | \$ 12,067.5 | \$ 11,112.0 | \$ 11,921.4 | \$ 10,970.8 |
| Allowance for loan losses ⁽¹⁾ | \$ 138.1 | \$ 129.5 | \$ 138.1 | \$ 129.5 |
| Allowance for loan losses as a percentage of ending managed receivables | 1.13% | 1.15% | 1.13% | 1.15% |
| Net credit losses on managed receivables | \$ 36.2 | \$ 33.2 | \$ 61.4 | \$ 55.6 |
| Annualized net credit losses as a percentage of total average managed receivables | 1.20% | 1.19% | 1.03% | 1.01% |
| Past due accounts as a percentage of ending managed receivables | 3.43% | 3.42% | 3.43% | 3.42% |
| Average recovery rate ⁽²⁾ | 47.9% | 45.7% | 47.8% | 46.7% |

⁽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. While in any individual period conditions may vary, over the past 10 fiscal years, the annual recovery rate has ranged from a low of 44% to a high of 60%, and it is primarily affected by the wholesale market environment.

CAF income increased 1.6% in the second quarter of fiscal 2019 and 3.7% in the first half of the year. The increase reflected the net effects of an increase in average managed receivables, a slightly lower total interest margin percentage and an increase in the provision for loan losses. Average managed receivables grew 8.6% and 8.7% in the second quarter and the first half of fiscal 2019, respectively, driven primarily by the rise in CAF loan originations in recent years. The growth in net loan originations in both the second quarter and the first half of fiscal 2019 resulted from our used vehicle sales growth, an increase in average amount financed and an increase in CAF's penetration rate.

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 5.7% in both the second quarter and the first half of fiscal 2019 from 5.8% in both corresponding prior year periods. 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 increased to \$40.0 million in the second quarter and \$70.9 million in the first half of fiscal 2019 from \$32.9 million and \$61.5 million, respectively, in the corresponding prior year periods, as a result of the increase in average managed receivables noted above as well as fluctuations that are often experienced with determining our quarterly loss reserve. Annualized net credit losses as a percentage of total average managed receivables and past due accounts as a percentage of ending managed receivables were relatively flat in both the second quarter and first half of fiscal 2019 compared to the comparable prior year periods. The allowance for loan losses as a percentage of ending managed receivables remained relatively stable at 1.13% as of August 31, 2018, compared with 1.15% as of August 31, 2017, and 1.11% as of February 28, 2018. 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 \$160.2 million and \$147.5 million in CAF Tier 3 receivables were outstanding as of August 31, 2018 and February 28, 2018, respectively. These loans have higher loss and delinquency rates than the remainder of the CAF portfolio, as well as higher contract rates. As of August 31, 2018 and February 28, 2018, 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 2019 and between 13 and 16 stores in fiscal 2020. We currently estimate capital expenditures will total approximately \$340 million in fiscal 2019.

We currently plan to open the following stores within 12 months from August 31, 2018. During this period, we will be entering ten new television markets and expanding our presence in five existing television markets. Of the 15 stores we plan to open during the 12 months ending August 31, 2019, 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 |
|---|--|-------------------------------|----------------------|
| Wilmington, North Carolina ⁽¹⁾ | Wilmington ⁽²⁾ | Wilmington | Q3 Fiscal 2019 |
| Lafayette, Louisiana ⁽¹⁾ | Lafayette ⁽²⁾ | Lafayette | Q3 Fiscal 2019 |
| Corpus Christi, Texas | Corpus Christi ⁽²⁾ | Corpus Christi | Q3 Fiscal 2019 |
| Shreveport, Louisiana | Shreveport ⁽²⁾ | Shreveport | Q3 Fiscal 2019 |
| Amherst, New York | Buffalo ⁽²⁾ | Buffalo | Q4 Fiscal 2019 |
| Melbourne, Florida | Orlando/Daytona Beach | Palm Bay/Melbourne | Q4 Fiscal 2019 |
| Montgomery, Alabama | Montgomery/Selma ⁽²⁾ | Montgomery | Q4 Fiscal 2019 |
| Vancouver, Washington | Portland | Portland/Vancouver | Q4 Fiscal 2019 |
| Kenner, Louisiana | New Orleans ⁽²⁾ | New Orleans | Q4 Fiscal 2019 |
| Memphis, Tennessee | Memphis | Memphis | Q1 Fiscal 2020 |
| Killeen, Texas | Waco/Temple ⁽²⁾ | Killeen/Temple | Q1 Fiscal 2020 |
| Pharr, Texas | Harlingen/Brownsville/McAllen ⁽²⁾ | McAllen/Edinburg/Mission | Q1 Fiscal 2020 |
| Pleasant Hill, California | San Francisco/Oakland/San Jose | San Francisco/Oakland | Q2 Fiscal 2020 |
| Lubbock, Texas | Lubbock ⁽²⁾ | Lubbock | Q2 Fiscal 2020 |
| Scottsdale, Arizona | Phoenix | Phoenix/Mesa/Scottsdale | Q2 Fiscal 2020 |

⁽¹⁾ Store opened subsequent to August 31, 2018 and prior to the filing of this Form 10-Q.

⁽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 non-recourse funding vehicles 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 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 six months of fiscal 2019, net cash provided by operating activities totaled \$110.9 million, compared with \$81.1 million in the prior year period. The net cash provided by operating activities included increases in auto loan receivables of \$675.6 million in the current year period and \$637.7 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 August 31, 2018, total inventory was \$2.36 billion, representing a decrease of \$33.3 million, or 1.4%, compared with the balance as of the start of the fiscal year. The decrease reflected the net effects of adding six new stores to our store base and the seasonal pattern of inventory levels. We typically build inventory in the latter portion of the fiscal year to better position ourselves for seasonal sales opportunities.

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

| <i>(In millions)</i> | Six Months Ended August 31 | |
|---|----------------------------|----------|
| | 2018 | 2017 |
| Net cash provided by operating activities | \$ 110.9 | \$ 81.1 |
| Add: Net issuances of non-recourse notes payable ⁽¹⁾ | 607.5 | 561.1 |
| Adjusted net cash provided by operating activities | \$ 718.4 | \$ 642.2 |

⁽¹⁾ 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 six months of the current fiscal year increased compared with the prior year period primarily due to an increase in net earnings when excluding non-cash expenses, which include depreciation and amortization, share-based compensation expense, the provisions for loan losses and cancellation reserves, and the deferred income tax provision. This increase was partially offset by a decline in cash provided by working capital.

Investing Activities. During the first six months of the fiscal year, net cash used in investing activities totaled \$174.9 million in fiscal 2019 compared with \$156.0 million in fiscal 2018. Capital expenditures were \$171.1 million in the current year period versus \$155.1 million in the prior year period. Capital expenditures primarily include store construction costs, real estate acquisitions for planned future store openings, and store remodeling expenses. 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.

As of August 31, 2018, 117 of our 194 used car stores were located on owned sites and 77 were located on leased sites, including 21 land-only leases and 56 land and building leases.

Financing Activities. During the first six months of the fiscal year, net cash provided by financing activities totaled \$108.3 million in fiscal 2019 compared with \$91.3 million in fiscal 2018. Included in these amounts were net increases in total non-recourse notes payable of \$607.5 million and \$561.1 million, respectively, which were used to provide the financing for the majority of the increases of \$675.6 million and \$637.7 million, respectively, in auto loan receivables (see “Operating Activities”).

During the first six months of fiscal 2019, we reduced net borrowings on our revolving credit facility with net repayments of \$155.5 million compared with \$137.0 million in the first six months of fiscal 2018. Net cash provided by financing activities was also impacted by stock repurchases of \$381.3 million in the first six months of fiscal 2019 compared with \$344.8 million in the first six months of fiscal 2018.

TOTAL DEBT AND CASH AND CASH EQUIVALENTS

| <i>(In thousands)</i> | As of August 31 | As of February 28 |
|--|------------------------|--------------------------|
| | 2018 | 2018 |
| Borrowings under revolving credit facility | \$ 45,296 | \$ 197,627 |
| Other long-term debt | 800,000 | 800,000 |
| Finance and capital lease obligations | 515,746 | 500,363 |
| Non-recourse notes payable | 12,252,143 | 11,644,615 |
| Total debt⁽¹⁾ | \$ 13,613,185 | \$ 13,142,605 |
| Cash and cash equivalents | \$ 37,147 | \$ 44,525 |

⁽¹⁾ Total debt excludes unamortized debt issuance costs. See Note 9 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 unsecured 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 direct 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 9 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 asset-backed term funding transactions. These non-recourse 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 non-recourse 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 non-recourse funding vehicles.

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 August 31, 2018, \$10.15 billion of non-recourse notes payable was outstanding related to asset-backed term funding transactions. These notes payable have scheduled maturities through April 2025, but they may mature earlier, depending on the repayment rate of the underlying auto loan receivables. During the first six months of fiscal 2019, we funded a total of \$2.76 billion in asset-backed term funding transactions.

As of August 31, 2018, \$2.11 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 August 31, 2018, the combined limit of our warehouse facilities was \$3.14 billion, and the unused warehouse capacity totaled \$1.03 billion. Of the combined limit, \$1.70 billion will expire in February 2019 and \$1.30 billion will expire in August 2019. Subsequent to the end of the quarter, the limit on the remaining \$140 million facility was increased to \$150 million and the expiration date was extended from September 2018 to September 2019. See Note 9 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 August 31, 2018, a total of \$750 million of board authorizations for repurchases were outstanding, with no expiration date. At that date, \$638.3 million remained available for repurchase. See Note 10 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, tax rates, 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 in the 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 tax law, including the effect of the 2017 Tax Act.
- 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 finance 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 37 of this report, our Annual Report on Form 10-K for the fiscal year ended February 28, 2018, 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, 2018. 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, 2018.

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 August 31, 2018, 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 14 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, 2018, 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. During the quarter ended August 31, 2018, the \$2 billion authorization was exhausted. 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 second quarter of fiscal 2019. 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 |
|---------------------|--|------------------------------------|---|---|
| June 1 - 30, 2018 | 557,075 | \$ 72.97 | 557,075 | \$ 768,826,073 |
| July 1 - 31, 2018 | 648,693 | \$ 76.04 | 648,693 | \$ 719,500,288 |
| August 1 - 31, 2018 | 1,085,955 | \$ 74.79 | 1,085,955 | \$ 638,277,709 |
| Total | 2,291,723 | | 2,291,723 | |

Item 6. Exhibits

[10.1](#) Consulting Agreement, dated June 27, 2018, between CarMax, Inc. and William C. Wood, Jr., filed as Exhibit 10.1 to CarMax's Current Report on Form 8-K, filed June 29, 2018 (File No. 1-31420), is incorporated herein 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.SCH XBRL Taxonomy Extension Schema Document

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document

101.LAB XBRL Taxonomy Extension Label Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

SIGNATURES

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

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

October 5, 2018