

SONIC AUTOMOTIVE INC  
Form 10-Q  
August 03, 2006  
Table of Contents

---

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

---

**FORM 10-Q**

---

(Mark One)

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

For the quarterly period ended June 30, 2006

OR

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

Commission file number 1-13395

---

**SONIC AUTOMOTIVE, INC.**

(Exact name of registrant as specified in its charter)

---

**DELAWARE**  
(State or other jurisdiction of

incorporation or organization)

**6415 Idlewild Road, Suite 109, Charlotte, North Carolina**  
(Address of principal executive offices)

**(704) 566-2400**

(Registrant's telephone number, including area code)

**56-2010790**  
(I.R.S. Employer

Identification No.)

**28212**  
(Zip Code)

## Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

---

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 is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act (check one).

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

As of July 28, 2006, there were 30,238,342 shares of Class A Common Stock and 12,029,375 shares of Class B Common Stock outstanding.

---

**Table of Contents**

**INDEX TO FORM 10-Q**

	<b>Page</b>
<b><u>PART I - FINANCIAL INFORMATION</u></b>	
ITEM 1. <u>Condensed Consolidated Financial Statements (Unaudited)</u>	3
<u>Condensed Consolidated Statements of Income</u>	
<u>Three and six month periods ended June 30, 2005 and June 30, 2006</u>	3
<u>Condensed Consolidated Balance Sheets</u>	
<u>December 31, 2005 and June 30, 2006</u>	4
<u>Condensed Consolidated Statement of Stockholders' Equity</u>	
<u>Six-month period ended June 30, 2006</u>	5
<u>Condensed Consolidated Statements of Cash Flows</u>	
<u>Six-month periods ended June 30, 2005 (as restated) and June 30, 2006</u>	6
<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	7
ITEM 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	20
ITEM 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	30
ITEM 4. <u>Controls and Procedures</u>	30
<b><u>PART II - OTHER INFORMATION</u></b>	
ITEM 1. <u>Legal Proceedings</u>	31
ITEM 1A. <u>Risk Factors</u>	32
ITEM 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	43
ITEM 4. <u>Submissions of Matters to a Vote of Security Holders</u>	44
ITEM 6. <u>Exhibits</u>	44
<u>SIGNATURES</u>	46

**Table of Contents****PART I - FINANCIAL INFORMATION****Item 1: Condensed Consolidated Financial Statements.****SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(Dollars and shares in thousands except per share amounts)****(Unaudited)**

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2005</b>	<b>2006</b>	<b>2005</b>	<b>2006</b>
<b>Revenues:</b>				
New vehicles	\$ 1,157,814	\$ 1,249,362	\$ 2,123,520	\$ 2,354,047
Used vehicles	278,580	336,726	539,876	637,352
Wholesale vehicles	129,558	128,451	239,143	257,721
<b>Total vehicles</b>	<b>1,565,952</b>	<b>1,714,539</b>	<b>2,902,539</b>	<b>3,249,120</b>
Parts, service and collision repair	240,844	273,446	466,641	540,394
Finance, insurance and other	46,153	45,755	87,619	91,724
<b>Total revenues</b>	<b>1,852,949</b>	<b>2,033,740</b>	<b>3,456,799</b>	<b>3,881,238</b>
<b>Cost of sales</b>	<b>1,573,926</b>	<b>1,725,746</b>	<b>2,926,773</b>	<b>3,281,212</b>
<b>Gross profit</b>	<b>279,023</b>	<b>307,994</b>	<b>530,026</b>	<b>600,026</b>
Selling, general and administrative expenses	210,429	242,537	408,672	469,996
Depreciation and amortization	3,622	6,870	7,025	11,637
<b>Operating income</b>	<b>64,972</b>	<b>58,587</b>	<b>114,329</b>	<b>118,393</b>
<b>Other income / (expense):</b>				
Interest expense, floor plan	(8,777)	(15,610)	(16,167)	(27,742)
Interest expense, other, net	(11,054)	(11,022)	(21,672)	(22,785)
Other income / (expense), net	12	(1)	24	(667)
<b>Total other expense</b>	<b>(19,819)</b>	<b>(26,633)</b>	<b>(37,815)</b>	<b>(51,194)</b>
<b>Income from continuing operations before income taxes</b>	<b>45,153</b>	<b>31,954</b>	<b>76,514</b>	<b>67,199</b>
Provision for income taxes	16,873	13,380	28,578	26,880
<b>Income from continuing operations</b>	<b>28,280</b>	<b>18,574</b>	<b>47,936</b>	<b>40,319</b>
<b>Discontinued operations:</b>				
Loss from operations and the sale of discontinued franchises	(1,945)	(10,299)	(5,927)	(17,827)
Income tax benefit	669	3,913	2,107	6,778
<b>Loss from discontinued operations</b>	<b>(1,276)</b>	<b>(6,386)</b>	<b>(3,820)</b>	<b>(11,049)</b>
<b>Net income</b>	<b>\$ 27,004</b>	<b>\$ 12,188</b>	<b>\$ 44,116</b>	<b>\$ 29,270</b>

Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

Basic earnings (loss) per share:								
Earnings per share from continuing operations	\$	0.68	\$	0.44	\$	1.15	\$	0.95
Loss per share from discontinued operations		(0.03)		(0.15)		(0.09)		(0.26)
Earnings per share	\$	0.65	\$	0.29	\$	1.06	\$	0.69
Weighted average common shares outstanding		41,731		42,414		41,739		42,288
Diluted earnings (loss) per share:								
Earnings per share from continuing operations	\$	0.65	\$	0.42	\$	1.10	\$	0.92
Loss per share from discontinued operations		(0.03)		(0.13)		(0.08)		(0.24)
Earnings per share	\$	0.62	\$	0.29	\$	1.02	\$	0.68
Weighted average common shares outstanding		45,421		46,270		45,440		46,238
Dividends declared per common share	\$	0.12	\$	0.12	\$	0.24	\$	0.24

See notes to unaudited condensed consolidated financial statements.

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

(Dollars in thousands)

	December 31, 2005	June 30, 2006 (Unaudited)
<b>ASSETS</b>		
Current Assets:		
Cash	\$ 7,566	\$ 18,342
Receivables, net	396,225	340,437
Inventories	1,016,457	1,051,815
Assets held for sale	73,837	219,358
Construction in progress expected to be sold in sale-leaseback transactions	95,131	70,500
Other current assets	27,484	28,293
<b>Total current assets</b>	<b>1,616,700</b>	<b>1,728,745</b>
Property and equipment, net	148,267	174,487
Goodwill, net	1,122,538	1,153,168
Other intangible assets, net	88,696	80,200
Other assets	49,300	58,380
<b>Total assets</b>	<b>\$ 3,025,501</b>	<b>\$ 3,194,980</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current Liabilities:		
Floor plan notes payable - trade	\$ 579,022	\$ 450,602
Floor plan notes payable - non-trade	410,296	649,370
Trade accounts payable	91,101	80,583
Accrued interest	17,378	18,687
Other accrued liabilities	167,060	172,172
Liabilities associated with assets held for sale - trade	45,953	93,334
Liabilities associated with assets held for sale - non-trade	6,937	57,323
Current maturities of long-term debt	2,747	2,727
<b>Total current liabilities</b>	<b>1,320,494</b>	<b>1,524,798</b>
Long-term debt	712,311	644,863
Other long-term liabilities	29,479	37,532
Deferred income taxes	132,419	131,140
Commitments and contingencies		
Stockholders Equity:		
Class A Common Stock; \$.01 par value; 100,000,000 shares authorized; 40,561,149 shares issued and 29,945,785 shares outstanding at December 31, 2005; 41,331,471 shares issued and 30,244,507 shares outstanding at June 30, 2006	403	411
Class B Common Stock; \$.01 par value; 30,000,000 shares authorized; 12,029,375 shares issued and outstanding at December 31, 2005 and June 30, 2006	121	121
Paid-in capital	433,654	450,691
Retained earnings	542,374	561,406
Accumulated other comprehensive income	20	
Deferred compensation related to stock-based compensation	(1,829)	
Treasury Stock, at cost (10,615,364 Class A shares held at December 31, 2005 and 11,086,964 Class A shares held at June 30, 2006)	(143,945)	(155,982)

Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

Total stockholders' equity	830,798	856,647
Total liabilities and stockholders' equity	\$ 3,025,501	\$ 3,194,980

See notes to unaudited condensed consolidated financial statements.

Table of Contents

## SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

(Dollars and shares in thousands)

(Unaudited)

	Class A		Class B		Deferred Compensation Related to Stock-Based Compensation	Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income	Total Stockholders Equity
	Common Stock Shares	Amount	Common Stock Shares	Amount						
<b>Balance at December 31, 2005</b>	<b>40,561</b>	<b>\$ 403</b>	<b>12,029</b>	<b>\$ 121</b>	<b>\$ (1,829)</b>	<b>\$ 433,654</b>	<b>\$ 542,374</b>	<b>\$ (143,945)</b>	<b>\$ 20</b>	<b>\$ 830,798</b>
Comprehensive income:										
Net income							29,270			29,270
Change in fair value of interest rate swap, net of tax benefit of \$13									(20)	(20)
Total comprehensive income										29,250
Adoption of SFAS No. 123-R					1,829	(1,829)				
Shares issued under stock compensation plans	770	8				11,771				11,779
Stock-based compensation expense						3,329				3,329
Income tax benefit associated with stock compensation plans						3,057				3,057
Income tax benefit associated with convertible note hedge						709				709
Dividends declared							(10,238)			(10,238)
Purchases of treasury stock								(12,037)		(12,037)
<b>Balance at June 30, 2006</b>	<b>41,331</b>	<b>\$ 411</b>	<b>12,029</b>	<b>\$ 121</b>	<b>\$</b>	<b>\$ 450,691</b>	<b>\$ 561,406</b>	<b>\$ (155,982)</b>	<b>\$</b>	<b>\$ 856,647</b>

See notes to unaudited condensed consolidated financial statements.



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

(Dollars in thousands)

(Unaudited)

	Six Months Ended June 30,	
	2005	2006
	As Restated (Note 1)	
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 44,116	\$ 29,270
Adjustments to reconcile net income to net cash used by operating activities:		
Depreciation and amortization of property and equipment	8,481	12,151
Provision for bad debt expense	4,918	5,774
Debt issue cost amortization	199	508
Debt discount / (premium) amortization, net	(51)	327
Deferred income taxes		(1,266)
Other amortization	140	189
Stock-based compensation expense	708	3,329
Income tax benefit associated with stock compensation plans	(572)	(3,057)
Equity interest in earnings of investee	(474)	(464)
Loss / (gain) on disposal of assets, including franchises	2,223	(625)
Impairment of property, equipment and franchise assets		12,602
Loss on exit of leased dealerships		4,914
Changes in assets and liabilities that relate to operations:		
Receivables	(17,026)	50,370
Inventories	(4,503)	(129,981)
Other assets	(8,855)	(7,472)
Floor plan notes payable - trade	(29,486)	(81,038)
Trade accounts payable and other liabilities	2,745	(8,837)
Total adjustments	(41,553)	(142,576)
Net cash provided by / (used in) operating activities	2,563	(113,306)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of businesses, net of cash acquired	(89,645)	(78,264)
Purchases of property and equipment	(37,082)	(55,019)
Proceeds from sales of property and equipment	12,822	26,811
Proceeds from sales of franchises	20,646	12,385
Distributions from equity investee	500	600
Net cash used in investing activities	(92,759)	(93,487)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Borrowings on revolving credit facilities	377,989	590,392
Repayments on revolving credit facilities	(297,632)	(651,918)
Debt issuance cost		(2,776)
Net borrowings on floor plan notes payable - non-trade	18,165	289,459
Proceeds from long-term debt	159	
Payments on long-term debt	(977)	(987)
Purchases of treasury stock	(4,935)	(12,037)

Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

Income tax benefit associated with convertible note hedge		709
Income tax benefit associated with stock compensation plans	572	3,057
Issuance of shares under stock option and purchase plans	5,159	11,779
Dividends paid	(10,017)	(10,109)
<b>Net cash provided by financing activities</b>	<b>88,483</b>	<b>217,569</b>
<b>NET INCREASE / (DECREASE) IN CASH</b>	<b>(1,713)</b>	<b>10,776</b>
<b>CASH, BEGINNING OF PERIOD</b>	<b>9,991</b>	<b>7,566</b>
<b>CASH, END OF PERIOD</b>	<b>\$ 8,278</b>	<b>\$ 18,342</b>
<b>SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING ACTIVITIES:</b>		
Increase / (Decrease) in accrual for purchases of property and equipment	\$ (765)	\$ 3,384
<b>SUPPLEMENTAL SCHEDULE OF NON-CASH FINANCING ACTIVITIES:</b>		
Restricted stock issuance	\$ 548	\$ 3,616
Change in fair value of cash flow hedging instruments (net of tax expense of \$496 and tax benefit of \$13 for the six months ended June 30, 2005 and 2006, respectively)	\$ 776	\$ (20)
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>		
Cash paid for interest, net of amount capitalized	\$ 44,364	\$ 57,090
Cash paid for income taxes	\$ 14,358	\$ 28,980

See notes to unaudited condensed consolidated financial statements.

---

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

I. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Basis of Presentation** The accompanying unaudited financial information for the three and six month periods ended June 30, 2006 has been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC). All significant intercompany accounts and transactions have been eliminated. These unaudited condensed consolidated financial statements reflect, in the opinion of management, all material adjustments (which include only normal recurring adjustments) necessary to fairly state the financial position and the results of operations for the periods presented. The results for interim periods are not necessarily indicative of the results to be expected for the entire fiscal year. These interim financial statements should be read in conjunction with the audited consolidated financial statements of Sonic for the year ended December 31, 2005, which were included in Sonic's Annual Report on Form 10-K.

**Reclassifications and Restatement** The statements of income for the quarter and six month period ended June 30, 2005 reflect reclassifications from the prior year presentation to include additional franchises sold and terminated or identified for sale subsequent to June 30, 2005 which had not been previously included in discontinued operations and exclude franchises which had been identified for sale as of June 30, 2005 but which Sonic subsequently decided to retain and operate as of June 30, 2006.

Certain cash flows in the accompanying condensed consolidated statement of cash flows for the six month period ended June 30, 2005 have been restated as the correction of an error to comply with Statement of Financial Accounting Standard (SFAS) No. 95, Statement of Cash Flows. Sonic's previous policy was to classify all of the cash flow activities associated with floor plan notes payable as an operating activity in its statement of cash flows consistent with industry practice. As of December 31, 2005, Sonic has decided to classify borrowings and repayments on floor plan notes payable for new vehicle inventory purchased from a manufacturer affiliated with floor plan lenders (floor plan notes payable trade) as an operating activity. Borrowings and repayments on floor plan notes payable for new vehicle inventory purchased from a manufacturer unaffiliated with the floor plan lender (floor plan notes payable non-trade) have been classified as a financing activity. This financing activity is shown net because these borrowings are due on demand from the floor plan lenders. In addition, Sonic's previous policy was to net the purchase of new vehicle inventory and the associated repayment of the seller's floor plan notes payable related to an acquisition within investing activities. Sonic now classifies the repayment of seller floor plan notes payable by Sonic's floor plan lenders as an additional cost of dealership acquisitions within investing activities with the corresponding borrowing in financing activities. Similarly, repayments of notes payable floor plan related to the disposal of a franchise were netted within investing activities. Sonic now classifies the repayment of its floor plan notes payable by the purchaser's floor plan lender as additional proceeds in investing activities with a corresponding repayment of floor plan notes payable trade or non-trade as appropriate.

**Table of Contents****SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

	<b>Six Months Ended June 30, 2005 (Dollars in thousands)</b>
Net cash used in operating activities as previously reported	\$ (1,337)
Reclassification of notes payable floor plan non-trade	5,404
Reclassification of notes payable floor plan trade related to acquisitions	7,431
Reclassification of notes payable floor plan trade related to dispositions	(8,037)
Other reclassifications	(898)
Net cash provided by operating activities, as restated	\$ 2,563
Net cash used in investing activities as previously reported	\$ (70,122)
Reclassification of notes payable floor plan related to acquisitions	(37,331)
Reclassification of notes payable floor plan trade related to dispositions	8,037
Reclassification of notes payable floor plan non-trade related to dispositions	6,157
Other reclassifications	500
Net cash used in investing activities, as restated	\$ (92,759)
Net cash provided by financing activities as previously reported	\$ 69,746
Reclassification of notes payable floor plan non-trade	(5,404)
Reclassification of notes payable floor plan related to acquisitions	29,726
Reclassification of notes payable floor plan non-trade related to dispositions	(6,157)
Other reclassifications	572
Net cash provided by financing activities, as restated	\$ 88,483

Additionally, Sonic has corrected its presentation within the condensed consolidated statement of cash flows related to borrowings and repayments under its revolving credit facilities. Such borrowings and repayments, which were formerly presented net are now presented gross. This correction had no effect on total cash flows provided by financing activities.

Further, in order to maintain consistency and comparability between periods, certain other amounts in Sonic's financial statements have been reclassified from previously reported balances to conform to the current period classification.

**Operating Lease Accruals** During the six month period ended June 30, 2006, Sonic's management decided to cease using several dealership properties which are leased under operating leases. Accordingly, operating lease exit accruals in the amount of \$3.8 million and \$4.9 million were established in the second quarter and six month period ended June 30, 2006, respectively. Of the \$3.8 million accrual established in the second quarter ended June 30, 2006, \$1.6 million was recorded in selling, general and administrative expenses and \$2.2 million was recorded within discontinued operations. Of the \$4.9 million accrual established in the six months ended June 30, 2006, \$1.6 million was recorded in selling, general and administrative expenses and \$3.3 million was recorded in discontinued operations. These operating lease accruals represent the present value of the lease payments, net of estimated sublease rentals, for the remaining life of the operating leases and other accruals necessary to satisfy the lease commitment to the landlord. A summary of the activity of these operating lease accruals consists of the following:

	<b>(dollars in thousands)</b>
Balance, December 31, 2005	\$ 601
Lease exit expense	4,914
Payments	(342)

Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

Balance, June 30, 2006

\$

5,173

Table of Contents

## SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

**Revenue Recognition** Amounts recorded as allowances for commission chargeback reserves were \$12.9 million and \$16.5 million at December 31, 2005 and June 30, 2006, respectively. During the second quarter ended June 30, 2006, Sonic recorded a \$6.2 million increase in the allowance as a result of a change in the estimate of future charge backs associated with finance commissions Sonic has received for originating third party loans for customers. This \$6.2 million increase was recorded in finance, insurance and other revenue.

**Recent Accounting Pronouncements** In June 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation ( FIN ) No. 48, Accounting for Uncertainty in Income Taxes . FIN No. 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, disclosure and transition. Sonic is currently evaluating the provisions of FIN No. 48, which will be effective for the first quarter of 2007, and has not determined the impact on Sonic s consolidated operating results and financial position.

## 2. BUSINESS ACQUISITIONS AND DISPOSITIONS

**Acquisitions** The aggregate purchase price for franchises acquired during the six month period ended June 30, 2006 totaled approximately \$78.3 million in cash, net of cash acquired, and was funded by cash from operations, borrowings under our revolving credit facilities and borrowings under notes payable floor plan. The balance sheet as of June 30, 2006 includes preliminary allocations of the purchase price of these acquisitions to the assets and liabilities acquired based on their estimated fair market values at the date of acquisition and are subject to final adjustment. As a result of these allocations, Sonic has recorded the following:

\$26.0 million of net assets relating to dealership operations;

\$3.2 million of intangible assets representing rights acquired under franchise agreements; and

\$49.1 million of goodwill, all of which is expected to be tax deductible.

**Dispositions** During the six month period ended June 30, 2006, Sonic sold several franchises. These disposals generated cash of \$12.4 million and resulted in net gains of \$0.3 million and \$0.2 million, which are included in discontinued operations in the statement of income for the second quarter and six month period ended June 30, 2006, respectively. Sonic enters into certain guarantees and indemnifications in connection with franchise dispositions see Note 9.

In the six month period ended June 30, 2006, Sonic identified 31 additional franchises to be held for sale. These franchises have been identified as held for sale because of unprofitable operations or other strategic considerations. These franchises are expected to be sold within one year from the date when the individual franchise was identified as held for sale. The operating results of these franchises are included in the loss from discontinued operations in Sonic s statements of income. Assets to be disposed of in connection with franchises not yet sold, which have been classified in assets held for sale in Sonic s balance sheets, consist of the following:

	December 31, 2005	June 30, 2006
	(Dollars in thousands)	
Inventories	\$ 54,890	\$ 164,119
Property and equipment, net	8,737	19,650
Goodwill	5,210	22,389
Franchise agreements	5,000	13,200

Assets held for sale	\$ 73,837	\$ 219,358
----------------------	-----------	------------

**Table of Contents****SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

Liabilities to be disposed in connection with these dispositions are comprised primarily of notes payable floor plan and are classified as liabilities associated with assets held for sale on Sonic's balance sheets. Revenues for franchises classified as discontinued operations were as follows:

	Second Quarter Ended June 30,		Six Months Ended June 30,	
	2005	2006	2005	2006
	(Dollars in thousands)			
Revenues	\$ 332,482	\$ 232,027	\$ 466,963	\$ 663,422

Property and equipment impairment expense of \$3.9 million and \$6.1 million was recorded during the second quarter and six month period ended June 30, 2006, respectively, in loss from discontinued operations in connection with activities to sell the associated franchises. This impairment expense was recorded based on the estimated fair value of the property and equipment to be sold in connection with the disposal of the associated franchises. Franchise asset impairment expense of \$1.6 million and \$2.5 million was also recorded in the second quarter and six month period ended June 30, 2006, respectively. This expense was related to both revising the estimated fair value of franchises held for sale as of December 31, 2005 and the identification of other franchises to be sold during the six month period ended June 30, 2006.

**3. INVENTORIES**

Inventories consist of the following:

	December 31, 2005	June 30, 2006
	(Dollars in thousands)	
New vehicles	\$ 801,116	\$ 918,309
Used vehicles	150,040	162,675
Parts and accessories	56,660	58,258
Other	63,531	76,692
Subtotal	1,071,347	1,215,934
Less inventories classified as assets held for sale	(54,890)	(164,119)
Inventories	\$ 1,016,457	\$ 1,051,815



**Table of Contents****SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****4. PROPERTY AND EQUIPMENT**

Property and equipment consists of the following:

	<b>December 31, 2005</b>	<b>June 30, 2006</b>
	<b>(Dollars in thousands)</b>	
Land	\$ 31,871	\$ 26,411
Building and improvements	101,702	126,716
Office equipment and fixtures	51,802	57,808
Parts and service equipment	38,059	42,187
Company vehicles	9,747	10,173
Construction in progress	79,488	72,452
<b>Total, at cost</b>	<b>312,669</b>	<b>335,747</b>
Less accumulated depreciation and amortization	(60,534)	(71,110)
<b>Subtotal</b>	<b>252,135</b>	<b>264,637</b>
Less assets held for sale	(8,737)	(19,650)
Less other current assets - construction in progress held for sale	(95,131)	(70,500)
<b>Property and equipment, net</b>	<b>\$ 148,267</b>	<b>\$ 174,487</b>

Other current assets - construction in progress held for sale represents dealership facilities that are or were expected to be completed and sold within one year in sale-leaseback transactions. These assets have been classified as other current assets on Sonic's balance sheets. Under the terms of the sale-leaseback transactions, Sonic sells the properties to a third party entity and enters into long-term operating leases on the facilities. Sonic sold \$14.4 million in dealership equipment and properties in sale-leaseback transactions during the six month period ended June 30, 2006 which resulted in no material gains or losses. Sonic has no continuing involvement or obligations under these arrangements other than lease payments.

Impairment expense related to property and equipment of \$3.2 million and \$3.6 million was recorded in selling, general and administrative expenses during the second quarter and six month period ended June 30, 2006, respectively. This impairment expense was related to decisions to abandon several construction projects and current market information which indicated that the fair value of land parcels held for sale was less than the recorded value. See Note 2 for other property and equipment impairment charges related to discontinued operations.

An adjustment to depreciation expense of \$2.1 million was recorded in the second quarter and six month period ended June 30, 2006. This adjustment was related to the reclassification of certain assets from other current assets - construction in progress to depreciable property and equipment based on strategic capital decisions which resulted in decisions not to sell these assets.

**Table of Contents****SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

## 5. GOODWILL AND INTANGIBLE ASSETS

The changes in the carrying amount of franchise agreements and goodwill for the six months ended June 30, 2006 were as follows:

	<b>Franchise</b>	
	<b>Agreements</b>	<b>Goodwill</b>
	<b>(Dollars in thousands)</b>	
Balance before assets held for sale classification, December 31, 2005	\$ 89,700	\$ 1,127,748
Amount classified as assets held for sale	(5,000)	(5,210)
<b>Balance, December 31, 2005</b>	<b>84,700</b>	<b>1,122,538</b>
Additions through current year acquisitions	3,200	49,091
Reductions from sales of franchises	(1,275)	(787)
Impairment expense (discontinued operations)	(2,525)	
Prior acquisition allocations		(495)
<b>Sub-total, June 30, 2006</b>	<b>84,100</b>	<b>1,170,347</b>
Increase in amount classified as assets held for sale	(8,200)	(17,179)
<b>Balance, June 30, 2006</b>	<b>\$ 75,900</b>	<b>\$ 1,153,168</b>

Franchise agreements and definite life intangible assets (\$4.3 million and \$4.0 million at June 30, 2006 and December 31, 2005, respectively) are classified as other intangible assets, net on Sonic's balance sheets except for the franchise agreements classified in assets held for sale.

**Table of Contents****SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

## 6. LONG-TERM DEBT

Long-term debt consists of the following:

	December 31, 2005	June 30, 2006
	(Dollars in thousands)	
\$550 million revolving credit facility bearing interest at 2.55 percentage points above LIBOR	\$ 131,746	\$
\$350 million revolving credit facility bearing interest at 2.00 percentage points above LIBOR		70,220
Senior Subordinated Notes bearing interest at 8.625%, net of discount of \$2,722 and \$2,600, respectively	272,278	272,400
Convertible Senior Subordinated Notes bearing interest at 5.25%, net of discount of \$2,063 and \$1,780, respectively	128,037	128,320
Convertible Senior Subordinated Notes bearing interest at 4.25%, net of discount of \$3,926 and \$3,571, respectively	156,074	156,429
Notes payable to a finance company bearing interest from 9.52% to 10.52%, including premiums of \$5,701 and \$5,267, respectively	30,197	29,061
Fair value of fixed to variable interest rate swaps	(3,684)	(9,105)
Other notes payable	410	265
	715,058	647,590
Less: current maturities	(2,747)	(2,727)
<b>Long-term debt</b>	<b>\$ 712,311</b>	<b>\$ 644,863</b>

Neither of the conversion features on the 5.25% or 4.25% convertible senior subordinated notes were satisfied during the six month period ended June 30, 2006. Sonic was in compliance with all financial covenants under the above long-term debt and credit facilities as of June 30, 2006.

**Table of Contents****SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****7. STOCK-BASED COMPENSATION**

Effective January 1, 2006, Sonic adopted SFAS No. 123(R), *Share-Based Payment*, using the modified prospective application transition method. Prior to Sonic's adoption of SFAS No. 123(R), benefits of tax deductions in excess of recognized compensation costs were reported as operating cash flows on the statement of cash flows. SFAS No. 123(R) requires excess tax benefits to be reported as a financing cash inflow rather than as a reduction of taxes paid on the statement of cash flows.

Sonic currently has four stock compensation plans, the Sonic Automotive, Inc. 2004 Stock Incentive Plan (the *2004 Plan*), the Sonic Automotive, Inc. 1997 Stock Option Plan (the *1997 Plan*), the First America Automotive, Inc. 1997 Stock Option Plan (the *First America Plan*), and the 2005 Formula Restricted Stock Plan for Non-Employee Directors (the *2005 Formula Plan*) (collectively, the *Stock Plans*).

The 2004 Plan and the 1997 Plan were adopted by the Board of Directors in order to attract and retain key personnel and currently authorize the issuance of options to purchase 2.0 million and 9.0 million shares of Class A common stock, respectively. Under the 2004 Plan and the 1997 Plan, options to purchase shares of Class A common stock may be granted to key employees of Sonic and its subsidiaries and to officers, directors, consultants and other individuals providing services to Sonic. The options are granted at the fair market value of Sonic's Class A common stock at the date of grant, vest over a period ranging from six months to three years, are exercisable upon vesting and expire ten years from the date of grant. The 2004 Plan also authorizes the issuance of restricted stock. Restricted stock issued under the 2004 plan generally vests at the end of a three year term. The 2005 Formula Plan provides for grants of restricted stock to non-employee directors and restrictions on those shares generally expire one year from the date of grant. Individuals receiving restricted shares under both the 2005 Formula Plan and the 2004 Plan have voting rights and receive dividends on unvested shares. The First America Plan was assumed by Sonic in connection with the purchase of First America Automotive in 1999. Although Sonic does not issue stock-based awards under the First America Plan, options to purchase Sonic's Class A common stock were outstanding under this plan during the six month period ended June 30, 2006. Sonic issues new shares of Class A common stock to employees and directors to satisfy its option exercise and stock grant obligations. To offset the effects of these transactions, Sonic will periodically buy back shares of Class A common stock after considering cash flow, market conditions and other factors.

A summary of the status of the options related to the Stock Plans is presented below:

	Options Outstanding (in thousands)	Exercise Price Per Share	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Balance - December 31, 2005	5,531	\$6.00 - 37.50	\$ 19.12		
Granted	641	23.94 - 26.42	25.40		
Exercised	(725)	6.00 - 26.92	15.43		\$ 8,045
Forfeited	(199)	12.41 - 37.50	25.56		
Balance - June 30, 2006	5,248	\$7.01 - 37.50	\$ 20.14	6.5	\$ 28,508
Exercisable	3,810	\$7.01 - 37.50	\$ 19.38	5.5	\$ 20,371
Fair value of options vested in the six month period ended June 30, 2006					\$ 3,807

The weighted average fair value of options granted in the six month period ended June 30, 2006 was \$7.86 per share and was estimated using the Black-Scholes option pricing model with the following weighted average assumptions:

Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

Dividend yield	1.82 - 2.01%
Risk free interest rates	4.54 - 4.87%
Expected lives	3.5 - 5.0 years
Volatility	36.60%

**Table of Contents****SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

Sonic used an expected term of three and a half to five years for current year option grants based on several facts associated with past grants and exercises. First, the historical exercise experience indicates that the expected term is at least three years (consistent with the three year graded vesting period attached to the majority of these options) and the majority of Sonic's grants are in the early to middle stages of their contractual terms of ten years; second, the contractual term of all of Sonic's options is ten years; and third, since Sonic began granting stock options in 1997, none of these stock option grants have completed their contractual term of ten years.

Expected volatility was estimated using Sonic's stock price over the last three years. Prior to this period, Sonic was a fast growing, new company in an un-established retail sector of the equity market. As such, the volatility of Sonic's stock between 1997 and 2002 was higher than what is expected in the future due to a change in strategy that includes slowing the pace of acquisitions and the payment of quarterly dividends and the establishment of the retail automotive sector of the equity market.

Sonic recognized compensation expense within selling, general and administrative expenses related to the options in the Stock Plans of \$1.1 million and \$2.4 million in the second quarter and six month period ended June 30, 2006, respectively. Tax benefits recognized related to the compensation expenses were \$0.4 million and \$0.9 million for the second quarter and six month period ended June 30, 2006, respectively. No compensation expense related to these plans was recorded in the six month period ended June 30, 2005. The total compensation cost related to unvested options not yet recognized at June 30, 2006 was \$7.8 million and is expected to be recognized over a weighted average period of 1.8 years. Sonic received \$11.8 million in cash from the exercise of stock options during the six month period ended June 30, 2006. Sonic's tax benefit associated with these stock option exercises was \$3.1 million during the six month period ended June 30, 2006.

A summary of the status of restricted stock and restricted stock unit grants related to the Stock Plans is presented below:

	<b>Unvested Restricted Stock and Restricted Stock Units (in thousands)</b>	<b>Weighted Average Grant Date Fair Value</b>
Balance - December 31, 2005	141	\$ 21.66
Granted	144	24.10
Balance - June 30, 2006	285	\$ 22.92

In the six month period ended June 30, 2006, approximately 144,000 restricted shares of Class A common stock and restricted stock units were awarded to Sonic's Board of Directors, executive officers and other key associates under the 2004 Plan. These awards were made in connection with establishing the objective performance criteria for 2006 incentive compensation and cliff-vest in three years. The shares and units are subject to forfeiture, in whole or in part, based upon specified measures of Sonic's earnings per share performance for the 2006 fiscal year, continuation of employment and compliance with any restrictive covenants contained in any agreement between Sonic and the respective officer and other key associates. These awards are generally subject to the same restrictions and rights as the shares of restricted stock granted to certain executive officers in 2004 and 2005, except that the restricted stock units do not have voting rights and that dividends on the restricted stock units are paid to the holders in the year subsequent to the dividend declarations. Sonic recognized compensation expense within selling, general and administrative expenses related to unvested restricted stock and restricted stock units of \$0.6 million and \$0.9 million in the second quarter and six month period ended June 30, 2006, respectively, and \$0.4 million and \$0.7 million in the second quarter and six month period ended June 30, 2005. Tax benefits recognized related to the compensation expenses were \$0.1 million and \$0.3 million for the second quarter and six month period ended June 30, 2005, and \$0.2 million and \$0.4 million for the second quarter and six month period ended June 30, 2006, respectively. Total compensation cost related to unvested restricted stock not yet recognized at June 30, 2006 was \$4.4 million and is expected to be recognized over a weighted average period of 1.9 years.



**Table of Contents****SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

Prior to the adoption of SFAS No. 123(R), Sonic accounted for stock option grants under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. In accordance with those provisions, because the exercise price of all options granted under those plans equaled the market value of the underlying stock at the grant date, no stock-based employee compensation cost was recorded in the accompanying financial statements for periods prior to January 1, 2006. Using the Black-Scholes option pricing model for all options granted, the following table illustrates what net income and earnings per share would have been if Sonic had applied the fair value recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation for the second quarter and six month period ended June 30, 2005:

	<b>Second Quarter Ended</b>	<b>Six Months Ended</b>
	<b>June 30, 2005</b>	<b>June 30, 2005</b>
	<b>(Dollars in thousands except per share amounts)</b>	
Net income as reported	\$ 27,004	\$ 44,116
Fair value compensation cost, net of tax benefits of \$956 for the three months ended June 30, 2005 and \$1,840 for the six months ended June 30, 2005	(1,593)	(3,066)
<b>Pro forma net income</b>	<b>\$ 25,411</b>	<b>\$ 41,050</b>
Basic earnings per share:		
Earnings as reported	\$ 0.65	\$ 1.06
Fair value compensation cost, net of tax benefit	(0.04)	(0.08)
<b>Pro forma earnings per share</b>	<b>\$ 0.61</b>	<b>\$ 0.98</b>
Diluted earnings per share:		
Earnings as reported	\$ 0.62	\$ 1.02
Fair value compensation cost, net of tax benefit	(0.03)	(0.07)
<b>Pro forma earnings per share</b>	<b>\$ 0.59</b>	<b>\$ 0.95</b>

**8. PER SHARE DATA AND STOCKHOLDERS' EQUITY**

The calculation of diluted earnings per share considers the potential dilutive effect of Sonic's contingently convertible debt issuances and stock options to purchase shares of Class A common stock under the Stock Plans. The following tables illustrate the dilutive effect of such items:



**Table of Contents****SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

	Second Quarter Ended June 30, 2005						
	Shares	Income		Loss		Net Income	
		From Continuing Operations		From Discontinued Operations		Per Share	
		Amount	Per Share Amount	Amount	Per Share Amount	Amount	Per Share Amount
Basic Earnings (Loss) Per Share	41,731	\$ 28,280	\$ 0.68	\$ (1,276)	\$ (0.03)	\$ 27,004	\$ 0.65
Effect of Dilutive Securities:							
5.25% contingently convertible debt	2,776	1,059		104		1,163	
Stock Compensation Plans	914						
Diluted Earnings (Loss) Per Share	45,421	\$ 29,339	\$ 0.65	\$ (1,172)	\$ (0.03)	\$ 28,167	\$ 0.62

	Second Quarter Ended June 30, 2006						
	Shares	Income		Loss		Net Income	
		From Continuing Operations		From Discontinued Operations		Per Share	
		Amount	Per Share Amount	Amount	Per Share Amount	Amount	Per Share Amount
Basic Earnings (Loss) Per Share	42,414	\$ 18,574	\$ 0.44	\$ (6,386)	\$ (0.15)	\$ 12,188	\$ 0.29
Effect of Dilutive Securities:							
4.25% contingently convertible debt	251						
5.25% contingently convertible debt	2,776	1,023		41		1,064	
Stock Compensation Plans	829						
Diluted Earnings (Loss) Per Share	46,270	\$ 19,597	\$ 0.42	\$ (6,345)	\$ (0.13)	\$ 13,252	\$ 0.29

	Six Months Ended June 30, 2005						
	Shares	Income		Loss		Net Income	
		From Continuing Operations		From Discontinued Operations		Per Share	
		Amount	Per Share Amount	Amount	Per Share Amount	Amount	Per Share Amount
Basic Earnings (Loss) Per Share	41,739	\$ 47,936	\$ 1.15	\$ (3,820)	\$ (0.09)	\$ 44,116	\$ 1.06
Effect of Dilutive Securities:							
5.25% contingently convertible debt	2,776	2,184		140		2,324	
Stock Compensation Plans	925						
Diluted Earnings (Loss) Per Share	45,440	\$ 50,120	\$ 1.10	\$ (3,680)	\$ (0.08)	\$ 46,440	\$ 1.02

Six Months Ended June 30, 2006

Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

	Income			Loss		Net Income	
	Shares	From Continuing Operations		From Discontinued Operations		Amount	Per Share Amount
		Amount	Per Share Amount	Amount	Per Share Amount		
(Amounts in Thousands Except Per Share Amounts)							
Basic Earnings (Loss) Per Share	42,288	\$ 40,319	\$ 0.95	\$ (11,049)	\$ (0.26)	\$ 29,270	\$ 0.69
Effect of Dilutive Securities:							
4.25% contingently convertible debt	275						
5.25% contingently convertible debt	2,776	2,112		103		2,215	
Stock Compensation Plans	899						
Diluted Earnings (Loss) Per Share	46,238	\$ 42,431	\$ 0.92	\$ (10,946)	\$ (0.24)	\$ 31,485	\$ 0.68

---

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

In addition to the stock options included in the table above, options to purchase 1.9 million and 1.1 million shares of Class A common stock were outstanding during the six month periods ended June 30, 2005 and 2006, respectively, but were not included in the computation of diluted earnings per share because the options were antidilutive.

9. CONTINGENCIES

**Legal Proceedings:**

Several of Sonic's Texas dealership subsidiaries have been named in three class action lawsuits brought against the Texas Automobile Dealers Association (TADA) and new vehicle dealerships in Texas that are members of the TADA. Approximately 630 Texas dealerships are named as defendants in two of the actions, and approximately 700 dealerships are named as defendants in the other action. The three actions allege that since January 1994, Texas automobile dealerships have deceived customers with respect to a vehicle inventory tax and violated federal antitrust and other laws. In April 2002, in two actions, the Texas state court certified two classes of consumers on whose behalf the actions would proceed. The Texas Court of Appeals subsequently affirmed the trial court's order of class certification in the state actions, and the Texas Supreme Court issued an order for the second time in September 2004 stating that it would not hear the merits of the defendant's appeal on class certification. The federal trial court conditionally certified a class of consumers in the federal antitrust case, but on appeal by the defendant dealerships, the U.S. Court of Appeals for the Fifth Circuit reversed the certification of the plaintiff class in October 2004 and remanded the case back to the federal trial court for further proceedings not inconsistent with the Fifth Circuit's ruling. The plaintiffs have appealed this ruling by the Fifth Circuit.

In June 2005, Sonic's Texas dealerships and several other dealership defendants entered into a settlement agreement with the plaintiffs in both the state and the federal cases that would settle each of the cases on behalf of Sonic's Texas dealerships. The settlements are contingent upon court approval, and the State court has not yet granted final approval of the settlements. The estimated expense of the proposed settlements is not a material amount to Sonic as a whole, and it includes Sonic's Texas dealerships issuing coupons for discounts off future vehicle purchases, refunding cash in certain circumstances, and paying attorneys' fees and certain costs. Under the terms of the settlements, Sonic's Texas dealerships would continue to itemize and pass through to the customer the cost of the inventory tax. If the TADA matters are not settled, Sonic's Texas dealership subsidiaries would then vigorously defend themselves and assert available defenses. In addition, Sonic may have rights of indemnification with respect to certain aspects of the TADA matters. However, an adverse resolution of the TADA matters could result in the payment of significant costs and damages and negatively impact Sonic's Texas dealerships' ability to itemize and pass through to the customer the cost of the vehicle inventory tax in the future, which could have a material adverse effect on Sonic's future results of operations, financial condition and cash flows.

Sonic is also a defendant in the matter of *Galura, et al. v. Sonic Automotive, Inc.*, a private civil action filed in the Circuit Court of Hillsborough County, Florida. In this action, originally filed on December 30, 2002, the plaintiffs allege that Sonic and Sonic's Florida dealerships sold an anti-theft protection product in a deceptive or otherwise illegal manner, and further sought representation on behalf of any customer of any of Sonic's Florida dealerships who purchased the anti-theft protection product since December 30, 1998. The plaintiffs are seeking monetary damages and injunctive relief on behalf of this class of customers. In June 2005, the court granted the plaintiffs' motion for certification of the requested class of customers, but the court has made no finding to date regarding actual liability in this lawsuit. Sonic subsequently filed a notice of appeal of the court's class certification ruling with the Florida Court of Appeals. Sonic intends to continue its vigorous defense of this lawsuit, including the aforementioned appeal of the trial court's class certification order, and to assert available defenses. However, an adverse resolution of this lawsuit could result in the payment of significant costs and damages, which could have a material adverse effect on Sonic's future results of operations, financial condition and cash flows.

Sonic is involved, and expects to continue to be involved, in numerous legal and administrative proceedings arising out of the conduct of Sonic's business, including regulatory investigations and private civil actions brought by plaintiffs purporting to represent a potential class or for which a class has been certified. Although Sonic vigorously defends itself in all legal and administrative proceedings, the outcomes of pending and future proceedings arising out of the conduct of Sonic's business, including litigation with customers, employment related lawsuits, contractual disputes, class actions, purported class actions and actions brought by governmental authorities, cannot be predicted with certainty. An unfavorable resolution of one or more of these matters could have a material adverse effect on Sonic's business, financial condition, results of operations, cash flows or prospects. Included in other accrued liabilities at December 31, 2005 and June 30, 2006 were \$3.5 million and \$3.8 million, respectively, in reserves that Sonic has provided for pending proceedings.



**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Guarantees and Indemnifications:**

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

In connection with franchise dispositions, certain of Sonic's dealership subsidiaries have assigned or sublet to the buyer their interests in real property leases associated with such dealerships. In general, the subsidiaries retain responsibility for the performance of certain obligations under such leases, including rent payments and repairs to leased property upon termination of the lease, to the extent that the assignee or sublessee does not perform. The total estimated rent payments remaining under such leases as of June 30, 2006 was approximately \$88.7 million. However, in accordance with the terms of the assignment and sublease agreements, the assignees and sublessees have generally agreed to indemnify Sonic and its subsidiaries in the event of non-performance. Additionally, in connection with certain dispositions, Sonic has obtained indemnifications from the parent company or owners of these assignees and sublessees in the event of non-performance.

In accordance with the terms of agreements entered into for the sale of Sonic's franchises, Sonic generally agrees to indemnify the buyer from certain exposure and costs arising subsequent to the date of sale, including environmental exposure and exposure resulting from the breach of representations or warranties made in accordance with the agreement. While Sonic's exposure with respect to environmental remediation and repairs is difficult to quantify, Sonic estimates that the maximum exposure associated with these general indemnifications if the counterparties failed to perform under their contractual obligations was approximately \$25.8 million at June 30, 2006. These indemnifications generally expire within a period of one to three years following the date of sale. The estimated fair value of these indemnifications was not material.

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

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

**Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations.**

The following discussion and analysis of the results of operations and financial condition should be read in conjunction with the Sonic Automotive, Inc. and Subsidiaries Unaudited Condensed Consolidated Financial Statements and the related notes thereto appearing elsewhere in this report, as well as the audited financial statements and related notes and Management's Discussion and Analysis of Financial Condition and Results of Operations appearing in our Annual Report on Form 10-K for the year ended December 31, 2005.

**Overview**

We are one of the largest automotive retailers in the United States. As of July 28, 2006, we owned dealership subsidiaries that operated 173 dealership franchises, representing 37 different brands of cars and light trucks at 151 locations, and 38 collision repair centers in 15 states. Our dealerships provide comprehensive services including sales of both new and used cars and light trucks, sales of replacement parts, performance of vehicle maintenance, manufacturer warranty repairs, paint and collision repair services, and arrangement of extended service contracts, financing, insurance and other aftermarket products (collectively, "F&I") for our automotive customers. Our brand diversity allows us to offer a broad range of products at a wide range of prices from lower priced, or economy vehicles, to luxury vehicles. We believe that this diversity reduces the risk of changes in customer preferences, product supply shortages and aging products. In addition, although vehicle sales are cyclical and are affected by many factors, including general economic conditions, consumer confidence, levels of discretionary personal income, interest rates and available credit, our parts, service and collision repair services are not closely tied to vehicle sales and are not as dependent upon near-term vehicle sales volume. As a result, we believe the diversity of these products and services reduces the risk of periodic economic downturns.

**Table of Contents****SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following is a detail of our new vehicle revenues by brand for the second quarter and six month period ended June 30, 2005 and 2006:

Brand (1)	Percentage of New Vehicle Revenues		Percentage of New Vehicle Revenues	
	Second Quarter Ended June 30,		Six Months Ended June 30,	
	2005	2006	2005	2006
Honda	15.4%	16.2%	15.3%	15.9%
BMW	13.4%	12.7%	13.8%	13.4%
Toyota	11.7%	13.5%	12.3%	12.9%
Mercedes	5.4%	9.3%	4.8%	9.3%
Cadillac	10.3%	8.6%	10.0%	8.5%
Ford	8.7%	8.1%	9.1%	8.3%
General Motors (2)	10.0%	8.1%	9.4%	8.0%
Lexus	7.2%	6.5%	7.1%	6.7%
Other Luxury (3)	2.3%	3.3%	2.3%	3.3%
Other (4)	2.7%	2.8%	2.6%	2.6%
Volvo	3.4%	2.5%	3.4%	2.5%
Nissan	2.1%	1.9%	2.2%	2.0%
Porsche	1.0%	1.4%	1.1%	1.4%
Hyundai	1.2%	1.3%	1.2%	1.2%
Acura	1.6%	1.1%	1.8%	1.2%
Audi	1.2%	0.9%	1.2%	1.0%
Chrysler (5)	1.6%	0.9%	1.5%	1.0%
Volkswagen	0.8%	0.9%	0.9%	0.8%
Total	100.0%	100.0%	100.0%	100.0%

- (1) In accordance with the provisions of SFAS No. 144, income statement data reflects reclassifications to exclude additional franchises sold, identified for sale, or terminated subsequent to June 30, 2005 which had not been previously included in discontinued operations. See Note 1 to our accompanying financial statements which discusses these and other factors that affect the comparability of the information for the periods presented.
- (2) Includes Buick, Chevrolet, GMC, Pontiac and Saturn
- (3) Includes Hummer, Infiniti, Jaguar, Land Rover, Maybach and Saab
- (4) Includes Isuzu, KIA, Mini, Scion and Subaru
- (5) Includes Chrysler, Dodge and Jeep

We have accounted for all of our dealership acquisitions using the purchase method of accounting and, as a result, we do not include in our financial statements the results of operations of these dealerships prior to the date they were acquired. Our financial statements discussed below reflect the results of operations, financial position and cash flows of each of our dealerships acquired prior to June 30, 2006. As a result of the effects of our acquisitions and other potential factors in the future, the historical consolidated financial information described in Management's Discussion and Analysis of Financial Condition and Results of Operations is not necessarily indicative of the results of operations, financial position and cash flows that would have resulted had such acquisitions occurred at the beginning of the periods presented, nor is it indicative of future results of operations, financial position and cash flows.

## Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

On July 19, 2006, we issued a press release describing charges recorded during the second quarter of 2006 in connection with the decision to exit certain facility leases and cancel various facility improvement projects, asset impairments and other asset write-offs, finance chargeback reserves, litigation matters and an adjustment of certain tax strategies. These charges are discussed in more detail in the respective areas under the subsequent heading **Results of Operations** . The amount and location of the charges in the accompanying condensed consolidated statements of income for the second quarter and the six month period ended June 30, 2006 are presented in the following table:



**Table of Contents****SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

	Finance, insurance and other revenue	Cost of sales	Continuing Operations Selling, general and administrative expenses	Depreciation and amortization (amounts in millions)	Provision for income taxes	Loss from operations and sale of discontinued franchises	Total
Real estate and other asset impairments / write-offs and lease exit costs	\$ 0.4	\$ 0.3	\$ 8.1	\$ 2.1	\$	\$ 7.8	\$ 18.7
Finance chargeback reserves	6.2						6.2
Legal accruals			1.2			0.5	1.7
Effective income tax rate adjustment					1.0		1.0
	\$ 6.6	\$ 0.3	\$ 9.3	\$ 2.1	\$ 1.0	\$ 8.3	\$ 27.6

**Results of Operations**

Except where otherwise noted, the following discussions are on a same store basis.

**Revenues***New Vehicles:*

	Second Quarter Ended		Units or \$	%	Six Months Ended		Units or \$	%
	6/30/2005	6/30/2006	Change	Change	6/30/2005	6/30/2006	Change	Change
<b>New Vehicle Units</b>								
Same Store	38,272	39,028	756	2.0%	70,638	72,266	1,628	2.3%
Acquisitions	336	2,081	1,745		346	3,978	3,632	
Total as Reported	38,608	41,109	2,501	6.5%	70,984	76,244	5,260	7.4%
<b>New Vehicle Revenue (in thousands)</b>								
Same Store	\$ 1,140,277	\$ 1,163,389	\$ 23,112	2.0%	\$ 2,105,408	\$ 2,184,755	\$ 79,347	3.8%
Acquisitions	17,537	85,973	68,436		18,112	169,292	151,180	
Total as Reported	\$ 1,157,814	\$ 1,249,362	\$ 91,548	7.9%	\$ 2,123,520	\$ 2,354,047	\$ 230,527	10.9%

**New Vehicle Revenue per Unit**

Same Store	\$ 29,794	\$ 29,809	\$ 15	0.1%	\$ 29,806	\$ 30,232	\$ 426	1.4%
------------	-----------	-----------	-------	------	-----------	-----------	--------	------

New unit sales at our import dealerships increased by 1,691 units, or 6.6%, and 2,335 units, or 4.9%, respectively, for the second quarter and six month period ended June 30, 2006, as compared to the same periods last year. This improvement was consistent with the changes in the industry's import new unit sales, which improved by 5.2% and 5.5%, respectively, over the same periods. Our top performing high-volume import brands during the second quarter and six month period ended June 30, 2006 were Toyota and Honda, which posted unit volume increases of 25.0% and 2.6% for the second quarter and 14.8% and 3.2% for the six month period, respectively. Our Toyota stores benefited from increased sales related to new and redesigned models. On the luxury import side, our Mercedes stores experienced significant improvements in unit volume, increasing by 25.3% and 16.3%, over the same periods. Our domestic new unit sales decreased by 935 units, or 7.3%, and 707 units, or 3.1%, respectively, over the same second quarter and six month period in 2005, which outperformed the industry's domestic new unit sales decreases of 12.5% and 7.9% during the same periods. For the second quarter and six month period ended June 30, 2006, our Ford stores

## Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

experienced the most significant improvement in new unit sales (excluding fleet) among our domestic brands, posting increases of 182 units, or 8.8%, and 264 units, or 6.7%, respectively. Of the remaining domestic brands, our GM (excluding Cadillac) stores experienced the largest decline in new unit sales volume (excluding fleet), decreasing by 15.5% and 13.0%, respectively, when compared to the same periods in 2005. These decreases can be attributed to the employee pricing strategy that was in place during the six month period ended June 30, 2005, which led to higher sales volume during that time period.

**Table of Contents****SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Our import dealerships had an average price per unit increase of \$543, or 1.8%, for the six month period ended June 30, 2006. This price increase was primarily due to the change in sales mix for the period compared to the same period in 2005. Our BMW, Honda and Mercedes stores experienced the most significant improvement in average price per unit, due to a greater percentage of sales coming from higher priced new and redesigned models. During the second quarter ended June 30, 2006, the average price per unit at our import dealerships remained relatively flat. Our domestic dealerships had an average new unit (excluding fleet) price increase of \$250, or 0.8%, and \$617, or 1.9%, respectively, for the second quarter and six month period ended June 30, 2006. In particular, our Cadillac stores benefited from the introduction of redesigned truck and SUV models. Of our remaining domestic brands, our Ford stores posted the most considerable increases in price per unit (excluding fleet), improving by 5.2% and 7.0%, respectively, as compared to the second quarter and six month period in 2005, due primarily to higher priced large trucks.

*Used Vehicles:*

	Second Quarter Ended		Units or \$	%	Six Months Ended		Units or \$	%
	6/30/2005	6/30/2006	Change	Change	6/30/2005	6/30/2006	Change	Change
<b>Used Vehicle Units</b>								
Same Store	14,975	16,705	1,730	11.6%	29,541	31,742	2,201	7.5%
Acquisitions	77	755	678		85	1,428	1,343	
Total as Reported	15,052	17,460	2,408	16.0%	29,626	33,170	3,544	12.0%
<b>Used Vehicle Revenue (in thousands)</b>								
Same Store	\$ 276,057	\$ 317,563	\$ 41,506	15.0%	\$ 537,132	\$ 600,100	\$ 62,968	11.7%
Acquisitions	2,523	19,163	16,640		2,744	37,252	34,508	
Total as Reported	\$ 278,580	\$ 336,726	\$ 58,146	20.9%	\$ 539,876	\$ 637,352	\$ 97,476	18.1%
<b>Used Vehicle Revenue per Unit</b>								
Same Store	\$ 18,435	\$ 19,010	\$ 575	3.1%	\$ 18,183	\$ 18,906	\$ 723	4.0%

Used vehicle unit sales increased at both our import and domestic stores for the second quarter and six month period ended June 30, 2006. A portion of the unit increase was due to our introduction of a used vehicle retail strategy process at a number of our dealerships. Our import stores contributed the majority of the increase, posting improvements of 13.9% and 9.0%, respectively, as compared to last year. On a brand basis, our BMW dealerships experienced the most significant increase in used unit sales, increasing by 33.6% and 29.5%, respectively, over the same time periods. The increase in the average price per unit of 3.1% and 4.0% for the second quarter and six month period ended June 30, 2006 was mostly attributable to a favorable used vehicle pricing market compared to last year. Certified pre-owned vehicle ( CPO ) sales as a percentage of total used vehicle sales decreased from 50.2% to 45.9% during the second quarter and from 49.9% to 46.8% during the six month period ended June 30, 2006, as compared to the same periods in 2005. The decrease in CPO sales as a percentage of total used sales was partially offset by an increase in our value used vehicle category, which experienced increases as a percentage of total used volume over both the second quarter and six month period ended June 30, 2006.

*Wholesale Vehicles:*

	Second Quarter Ended		Units or \$	%	Six Months Ended		Units or \$	%
	6/30/2005	6/30/2006	Change	Change	6/30/2005	6/30/2006	Change	Change

Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

Wholesale Vehicle Units								
Same Store	13,798	12,427	(1,371)	(9.9)%	25,398	24,234	(1,164)	(4.6)%
Acquisitions	627	1,155	528		1,138	2,359	1,221	
Total as Reported	14,425	13,582	(843)	(5.8)%	26,536	26,593	57	0.2%
Wholesale Vehicle Revenue (in thousands)								
Same Store	\$ 121,307	\$ 112,361	\$ (8,946)	(7.4)%	\$ 224,014	\$ 225,029	\$ 1,015	0.5%
Acquisitions	8,251	16,090	7,839		15,129	32,692	17,563	
Total as Reported	\$ 129,558	\$ 128,451	\$ (1,107)	(0.9)%	\$ 239,143	\$ 257,721	\$ 18,578	7.8%
Wholesale Revenue per Unit								
Same Store	\$ 8,792	\$ 9,042	\$ 250	2.8%	\$ 8,820	\$ 9,286	\$ 466	5.3%

**Table of Contents****SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Higher revenues realized in the six month period ended June 30, 2006 were driven by an increase in price per unit of \$466, or 5.3%, despite a 4.6% decline in unit volume. A portion of the wholesale unit decrease was due to the increase in used retail units (see *Used Vehicles* above). Wholesale pricing fluctuations followed those experienced in used retail sales and were consistent with the industry for both the second quarter and six month period ended June 30, 2006.

*Parts, Service and Collision Repair ( Fixed Operations ):*

	Second Quarter Ended		\$	%	Six Months Ended		\$	%
	6/30/2005	6/30/2006	Change	Change	6/30/2005	6/30/2006	Change	Change
Fixed Operations Revenue (in thousands)								
Same Store	\$ 236,560	\$ 249,560	\$ 13,000	5.5%	\$ 461,964	\$ 491,862	\$ 29,898	6.5%
Acquisitions	4,284	23,886	19,602		4,677	48,532	43,855	
Total as Reported	\$ 240,844	\$ 273,446	\$ 32,602	13.5%	\$ 466,641	\$ 540,394	\$ 73,753	15.8%

Strong customer pay increases of \$11.5 million, or 8.8%, and \$26.5 million, or 10.4%, respectively, during the second quarter and six month period ended June 30, 2006, were primarily responsible for the respective increases in Fixed Operations revenue. Import and luxury import brands drove the majority of these increases in customer pay revenue for the second quarter and six month period ended June 30, 2006. Our BMW, Honda, Toyota, Lexus, and Mercedes stores accounted for \$8.5 million and \$18.6 million of the customer pay revenue increases, over the same periods respectively. Warranty revenues also improved, increasing by \$1.0 million, or 1.8%, and \$1.1 million, or 1.0%, respectively, during the second quarter and six month period ended June 30, 2006, as compared to the same periods last year.

*Finance, Insurance and Other ( F & I ):*

	Second Quarter Ended		\$	%	Six Months Ended		\$	%
	6/30/2005	6/30/2006	Change	Change	6/30/2005	6/30/2006	Change	Change
Finance, Insurance and Other Revenue (in thousands)								
Same Store	\$ 44,537	\$ 43,421	\$ (1,116)	(2.5)%	\$ 84,605	\$ 86,018	\$ 1,413	1.7%
Acquisitions	1,616	2,334	718		3,014	5,706	2,692	
Total as Reported	\$ 46,153	\$ 45,755	\$ (398)	(0.9)%	\$ 87,619	\$ 91,724	\$ 4,105	4.7%

**Total F&I Revenue per Unit**

Same Store, Excluding Fleet Units	\$ 1,042	\$ 991	\$ (51)	(4.9)%	\$ 1,979	\$ 1,964	\$ (15)	(0.8)%
-----------------------------------	----------	--------	---------	--------	----------	----------	---------	--------

An overall retail unit increase, as well as an increase in substantially all of our F&I categories, were responsible for the increase in F&I revenue for the six month period ended June 30, 2006, as compared to the same period last year. The decrease in F&I revenue for the second quarter ended June 30, 2006 and the decrease in F&I per unit over both periods can be mainly attributed to a \$6.2 million increase in our allowance for estimated finance chargebacks that was recorded in the second quarter ended June 30, 2006 as a result of a change in estimate for this allowance.

*Gross Profit and Gross Margins*

## Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

The overall increase in the same store gross margin percentage for the six month period ended June 30, 2006 can be partly attributed to a change in revenue mix as shown in the table below. Specifically, we experienced increases in both our used vehicle and our Fixed Operations activities, which generate higher gross margins. For the three and six month periods ended June 30, 2006, the basis point increases experienced in our new vehicle gross margin rates can be attributed to the introduction of new models and the redesign of existing models by many of our brands.

**Table of Contents****SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

	Second Quarter Ended		Basis Point	Six Months Ended		Basis Point
	6/30/2005	6/30/2006	Change	6/30/2005	6/30/2006	Change
<b>Revenues as a Percentage of Total Revenues</b>						
New Vehicles	62.7%	61.7%	(100)	61.7%	60.9%	(80)
Used Vehicles	15.2%	16.8%	160	15.7%	16.7%	100
Wholesale Vehicles	6.7%	6.0%	(70)	6.6%	6.3%	(30)
Fixed Operations	13.0%	13.2%	20	13.5%	13.7%	20
Finance, Insurance and Other	2.4%	2.3%	(10)	2.5%	2.4%	(10)
<b>Total Revenues</b>	<b>100.0%</b>	<b>100.0%</b>		<b>100.0%</b>	<b>100.0%</b>	

The overall gross margin rates on our various revenue lines on a same store basis were as follows:

	Second Quarter Ended		Basis Point	Six Months Ended		Basis Point
	6/30/2005	6/30/2006	Change	6/30/2005	6/30/2006	Change
New Vehicles	7.3%	7.4%	10	7.3%	7.4%	10
Used Vehicles	10.5%	10.4%	(10)	10.7%	10.7%	
Wholesale Vehicles	(0.3)%	(1.7)%	(140)		(0.8)%	(80)
Fixed Operations	49.7%	50.2%	50	49.6%	49.9%	30
Finance, Insurance and Other	100.0%	100.0%		100.0%	100.0%	
Overall gross margin	15.1%	15.1%		15.4%	15.5%	10
<b>Selling, General and Administrative Expenses ( SG&amp;A )</b>						

For the second quarter and six month period ended June 30, 2006, reported SG&A expenses increased \$32.1 million, or 15.3%, and \$61.3 million, or 15.0%, respectively, as compared to the same periods last year, due primarily to gross profit growth from both same store and acquisitions. As a percentage of gross profit, operating expenses increased 330 basis points and 120 basis points, respectively, for the second quarter and six month period ended June 30, 2006. These increases can be mainly attributed to a number of large expenses recorded in the six month period ended June 30, 2006. For the second quarter and six month period ended June 30, 2006, these large expenses included property and equipment impairment charges and other asset write-offs of \$6.5 million and \$6.9 million, respectively, which represent 210 and 110 basis point increases in SG&A as a percentage of gross profit, respectively. In addition, legal accruals of \$1.8 million and \$2.1 million were recorded during the second quarter and six month period, respectively, which represent 60 and 30 basis point increases in SG&A as a percentage of gross profit, respectively. Lease exit accruals of \$1.6 million for the second quarter and six month period ended June 30, 2006, which represented 50 and 30 basis point increases in SG&A as a percentage of gross profit, respectively, were also recorded.

Same store advertising expense was relatively flat for both the second quarter and six month period ended June 30, 2006, as compared to the same periods last year. Same store compensation expense increased \$4.5 million and \$10.5 million over the same periods, respectively, mainly due to higher unit volume compared with last year. However, same store compensation expense decreased 10 basis points and 50 basis points, respectively, as a percentage of gross profit. Same store rent expense increased \$3.1 million and \$5.8 million, respectively, due to consumer-price-index increases on dealership leases and \$0.6 million of the lease exit accruals discussed above. As a percentage of gross profit, same store rent expense increased 70 basis points and 50 basis points, over the same periods. Other expenses increased \$0.3 million for the second quarter and decreased \$0.5 million for the six month period ended June 30, 2006, as compared with the same periods in 2005. As a percentage of gross profit, other expenses decreased 50 basis points and 100 basis points, respectively, mainly due to lower bad debt expense, equipment rental and data processing.

**Depreciation and Amortization**

## Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

Reported depreciation and amortization expense increased for the second quarter and six month period ended June 30, 2006 over the comparable periods in 2005 by \$3.2 million, or 89.7%, and \$4.6 million, or 65.7%, respectively. These increases were due to acquisitions, the completion of leasehold improvement projects, other general capital expenditures and an adjustment to depreciation expense in the second quarter ended June 30, 2006. This adjustment to depreciation expense of \$2.1 million was related to the re-classification of certain assets from other current assets - construction in progress to depreciable property and equipment based on strategic capital decisions which resulted in decisions not to sell these assets.



**Table of Contents****SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS*****Interest Expense, Floor Plan***

The weighted average floor plan interest rate for new vehicles incurred by continuing dealerships was 5.6% for the second quarter ended June 30, 2006, compared to 4.1% for the second quarter ended June 30, 2005, which increased new vehicle floor plan interest expense by \$3.4 million. The average new vehicle floor plan notes payable balance from continuing dealerships increased to \$1,109.2 million during the second quarter of 2006 from \$867.9 million during the second quarter of 2005, resulting in increased new vehicle floor plan interest expense of \$3.4 million.

The weighted average floor plan interest rate for new vehicles incurred by continuing dealerships was 5.5% for the six month period ended June 30, 2006, compared to 3.9% for the six month period ended June 30, 2005, which increased new vehicle floor plan interest expense by \$6.9 million. The average new vehicle floor plan notes payable balance from continuing dealerships increased to \$1,011.5 million during the six month period ended June 30, 2006 from \$840.8 million during the six month period ended June 30, 2005, resulting in increased new vehicle floor plan interest expense of \$4.7 million.

Our new vehicle floor plan interest expenses are substantially offset by amounts received from manufacturers in the form of floor plan assistance. These payments are credited against cost of sales upon the sale of the vehicle. During the second quarter and six month period ended June 30, 2006, our new vehicle floor plan interest exceeded the amounts we recognized in our income statement (for continuing dealerships) from floor plan interest assistance by \$6.1 million and \$10.2 million, respectively. Conversely, in the second quarter and six month period ended June 30, 2005, floor plan assistance exceeded new vehicle floor plan interest by \$0.4 million and \$0.3 million, respectively.

Our used floor plan facility, which is part of our new syndicated credit facility executed during the first quarter of 2006, bears interest at 1.125% above 30 day LIBOR (which was 5.33% at June 30, 2006). Interest expense on the used facility was approximately \$1.7 million and \$2.4 million for the second quarter and six month period ended June 30, 2006, respectively, compared to \$0 in the same periods in 2005.

***Interest Expense, Other***

Interest expense, other for 2006 compared to 2005 is summarized in the table below:

	Second Quarter Ended June 30, 2006 Increase/(decrease)  (in millions)	Six Months Ended June 30, 2006 Increase/(decrease)  (in millions)
<b>Interest rates</b>		
Increase in the average interest rate on our revolving credit facilities from 5.71% to 7.69% and from 5.52% to 7.48% for the three and six months ended June 30, 2006, respectively	\$ 1.4	\$ 2.6
Savings related to the issuance of \$160.0 million of 4.25% Convertible Notes	(0.8)	(1.6)
<b>Debt balances</b>		
Decrease in debt balances	(1.0)	(0.1)
<b>Other factors</b>		
Increase in capitalized interest	(0.2)	(0.4)
Incremental interest savings related to floating to fixed interest rate swaps	(0.3)	(0.8)
Incremental interest expense related to fixed to floating interest rate swaps	0.6	0.9
Other, net	0.3	0.5
	\$	\$ 1.1

***Other Income/(Expense)***

Other expense increased for the six month period ended June 30, 2006 due to expenses incurred in connection with the early pay-off of our \$550.0 million revolving credit facility in the first quarter of 2006.

---

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

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

***Income Taxes***

The overall effective tax rates of 43.7% and 40.7% for the second quarter and six month period ended June 30, 2006, respectively, increased over the comparable prior period effective rate of 37.5% for both the second quarter and six month period ended June 30, 2005, primarily due to the adjustment of certain tax planning strategies. We expect the rate for the remainder of 2006 to be between 39.5% and 40.5%.

***Loss From Discontinued Operations***

The loss from operations and the sale of discontinued franchises increased in the second quarter and the six month period ended June 30, 2006 by \$8.4 million and \$11.9 million, respectively, from the comparable prior year periods primarily due to charges of \$8.3 million recorded in the second quarter of 2006. These charges include \$1.6 million related to the impairment of franchise assets, \$2.3 million related to lease exit costs, \$3.9 million related to the impairment of land balances and construction in progress projects and \$0.5 million related to legal matters.

***Liquidity and Capital Resources***

We require cash to finance acquisitions and fund debt service and working capital requirements. We rely on cash flows from operations, borrowings under our various credit facilities and offerings of debt and equity securities to meet these requirements.

Because the majority of our consolidated assets are held by our dealership subsidiaries, the majority of our cash flows from operations is generated by these subsidiaries. As a result, our cash flows and ability to service debt depend to a substantial degree on the results of operations of our subsidiaries and their ability to provide us with cash. Uncertainties in the economic environment as well as uncertainties associated with the ultimate resolution of geopolitical conflicts may therefore affect our overall liquidity.

On February 17, 2006, we entered into a new four-year syndicated credit facility (the *New Credit Facility*) with 14 financial institutions, including three manufacturer-affiliated finance companies, providing for up to \$1.2 billion in revolving credit and floor plan financing. The *New Credit Facility* replaces the *Revolving Facility* (which was terminated February 17, 2006) and a portion of our existing floor plan financing arrangements and extends the maturity of payments under those prior credit facilities from 2007 to 2010. Our *New Credit Facility* provides a \$350.0 million revolving credit facility, a \$700.0 million new vehicle inventory floor plan facility and a \$150.0 million used vehicle inventory floor plan facility. See *Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources* in our Annual Report on Form 10-K for the year ended December 31, 2005 for a description of the *New Credit Facility*.

***Floor Plan Facilities***

The weighted average interest rate for all of our new vehicle floor plan facilities (both continuing and discontinued operations) was 5.8% and 4.2% for the second quarter ended June 30, 2006 and 2005, respectively, and 5.7% and 4.0% for the six month periods ended June 30, 2006 and 2005, respectively. In the second quarter ended June 30, 2006, we received approximately \$12.4 million in manufacturer assistance, which was approximately \$6.0 million less than the amount we paid for floor plan interest. In the six month period ended June 30, 2006, we received approximately \$22.1 million in manufacturer assistance, which was approximately \$10.9 million less than the amount we paid for floor plan interest. Interest payments under each of our floor plan facilities are due monthly, and we are generally not required to make principal repayments prior to the sale of the vehicles. We were in compliance with all restrictive covenants as of June 30, 2006.

The weighted average interest rate for our used vehicle floor plan facility (whose interest expense is allocated to discontinued and continuing operations) was 6.2% and 6.1% for the second quarter and six month period ended June 30, 2006, respectively.

***Long-Term Debt and Credit Facilities***

*The Revolving Credit Facility:* At June 30, 2006, our revolving credit facility (part of the *New Credit Facility*) had a borrowing limit of \$350.0 million (the *Revolving Credit Facility*), subject to a borrowing base calculated on the basis of our receivables, inventory and equipment and a pledge of certain additional collateral by one of our affiliates (the borrowing base was approximately \$350.0 million at June 30, 2006). The

## Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

amount available to be borrowed under the Revolving Credit Facility is reduced on a dollar-for-dollar basis by the cumulative face amount of outstanding letters of credit. At June 30, 2006, we had \$75.7 million in letters of credit outstanding and \$204.1 million of borrowing availability.

**Table of Contents****SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

At June 30, 2006, the outstanding balance and availability on our long-term debt and credit facilities were as follows (in millions):

	Interest Rate (1)	Outstanding Balance	Additional Borrowing Availability
Revolving Credit Facility (matures February 2010)	LIBOR + 2.00%(2)	\$ 70.2	\$ 204.1
Senior Subordinated Notes (mature August 2013)	8.625%	\$ 272.4	\$
5.25% Convertible Senior Subordinated Notes (mature May 2009) (3)	5.25%	\$ 128.3	\$
4.25% Convertible Senior Subordinated Notes (mature November 2015 and are redeemable on or after October 2010) (3)	4.25%	\$ 156.4	\$
<b>Mortgage Facility:</b>			
Construction Loan (matures December 2007) (4)	LIBOR + 2.25%	\$	50.0
Permanent Loan (matures December 2012) (4)	LIBOR + 2.00%	\$	100.0
Notes Payable to a Finance Company (mature November 2015 through September 2016)	10.19%(5)	\$ 29.1	\$

(1) Six-month LIBOR was 5.59% at June 30, 2006.

(2) Interest rate on the revolving Credit Facility is based on a performance - based grid that ranges from 1.75% to 2.75% above LIBOR.

(3) Notes were not convertible at any time during the six months ended June 30, 2006.

(4) Total combined borrowings under the Construction and Permanent Loans are limited to \$100,000.

(5) Weighted average rate.

We were in compliance with all of the restrictive and financial covenants under all our long-term debt and credit facilities as of June 30, 2006.

**Dealership Acquisitions and Dispositions**

In the six month period ended June 30, 2006, we acquired franchises for an aggregate purchase price of \$78.3 million in cash, net of cash acquired, using cash from operations, borrowings under the Revolving Credit Facility and borrowings under floor plan notes payable. During the six month period ended June 30, 2006, the disposition of several franchises generated cash of \$12.4 million.

**Sale-Leaseback Transactions**

During the six month period ended June 30, 2006, we sold \$14.4 million in dealership facilities in sale-leaseback transactions. We have no continuing obligations under these arrangements other than lease payments.

**Capital Expenditures**

Our capital expenditures include the construction of new dealerships and collision repair centers, building improvements and equipment purchased for use in our dealerships. Capital expenditures in the six month period ended June 30, 2006 were approximately \$55.0 million, of which approximately \$37.4 million related to the construction of new dealership facilities and collision repair centers. Once completed, these new dealership facilities and collision repair centers are generally sold in sale-leaseback transactions. Capital expenditures incurred during the six month period ended June 30, 2006 expected to be sold within a year in sale-leaseback transactions or already sold in 2006 were \$24.7 million. We do not expect any significant gains or losses from these sales. As of June 30, 2006, commitments for facilities construction projects totaled approximately \$38.3 million. We expect \$13.4 million of this amount to be financed through future sale-leaseback transactions.

**Stock Repurchase Program**

## Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

As of June 30, 2006, our Board of Directors had authorized our management to expend up to \$185.0 million to repurchase shares of our Class A common stock or redeem securities convertible into Class A common stock. In the six month period ended June 30, 2006,

---

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

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

we repurchased 471,600 shares for approximately \$12.0 million. This cash outflow was offset by proceeds received from the exercise of stock options under stock compensation plans of \$11.8 million. As of July 28, 2006, we had \$15.0 million remaining to repurchase shares under our Board authorization.

***Dividends***

During the second quarter of 2006, our Board of Directors approved a quarterly cash dividend of \$0.12 per share for shareholders of record on June 15, 2006, which was paid on July 15, 2006. Subsequent to June 30, 2006, our Board of Directors approved a quarterly cash dividend of \$0.12 per share for stockholders of record on September 15, 2006, which will be paid on October 15, 2006.

***Cash Flows***

For the six month period ended June 30, 2006, net cash used in operating activities was \$113.3 million. This use of cash was comprised of cash outflows for inventories and floor plan notes payable - trade somewhat offset by a reduction of receivables. The large pay down of our notes payable-floor plan-trade was attributable to the refinancing of several of our new vehicle trade financing agreements with the non-trade syndicated new vehicle floor plan agreement in the first quarter of 2006. Net cash used in investing activities for the first six months of 2006 was \$93.5 million, which consisted mostly of capital expenditures and dealership acquisitions, which was partially offset by proceeds received from dealership dispositions and sale-leaseback transactions. Net cash provided by financing activities for the six month period ended June 30, 2006 was \$217.6 million, comprised mostly of the increase of floor plan notes payable - non-trade offset by net repayments on our Revolving Credit Facility.

We are currently evaluating strategic alternatives for our wholly owned finance subsidiary, Cornerstone Acceptance Corporation ( "Cornerstone" ), which include selling Cornerstone or selling all or a portion of Cornerstone's outstanding notes receivable. We anticipate that proceeds from either type of sale will be used to reduce our leverage. Cornerstone's outstanding notes receivable at June 30, 2006 was \$55.6 million, net of an allowance for credit losses of \$8.6 million.

***Guarantees and Indemnifications***

In connection with the operation and disposition of dealership franchises, we have entered into various guarantees and indemnifications. See Note 9 to the accompanying condensed consolidated financial statements.

***Future Liquidity Outlook***

We believe our best source of liquidity for future growth remains cash flows generated from operations combined with the availability of borrowings under our new and used floor plan financing (or any replacements thereof) and the Revolving Credit Facility. Though uncertainties in the economic environment as well as uncertainties associated with geopolitical conflicts may affect our ability to generate cash from operations, we expect to generate more than sufficient cash flow to fund our debt service, quarterly cash dividends and working capital requirements and any seasonal operating requirements, including our currently anticipated internal growth for our existing businesses, for the foreseeable future. Once these needs are met, we may use remaining cash flow to support our acquisition strategy or repurchase shares of our Class A common stock or publicly-traded debt securities, based on market conditions and other factors.

***Off-Balance Sheet Arrangements***

See Management's Discussion and Analysis of Financial Condition and Results of Operations - Off-Balance Sheet Arrangements in our Annual Report on Form 10-K for the year ended December 31, 2005 for a description of our off-balance sheet arrangements.

***Seasonality***

## Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

Our operations are subject to seasonal variations. The first and fourth quarters generally contribute less revenue, operating profits and cash flows than the second and third quarters. Weather conditions, the timing of manufacturer incentive programs and model changeovers cause seasonality in new vehicle demand. Parts and service demand remains more stable throughout the year.



---

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

**Item 3: Quantitative and Qualitative Disclosures About Market Risk.**

***Interest Rate Risk***

Our variable rate notes payable floor plan, New Credit Facility borrowings and other variable rate notes expose us to risks caused by fluctuations in the underlying interest rates. The total outstanding balance of such instruments was \$1,321.5 million at June 30, 2006. A change of 100 basis points in the underlying interest rate would have caused a change in interest expense of \$7.3 million in the six month period ended June 30, 2006. Of the total change in interest expense, \$5.4 million would have resulted from notes payable floor plan.

Our exposure to notes payable floor plan is mitigated by floor plan assistance payments received from manufacturers that are generally based on rates similar to those incurred under our floor plan financing arrangements. These payments are capitalized as an offset to inventory and charged against cost of sales when the associated inventory is sold. During the six month period ended June 30, 2006, the amounts we paid for floor plan interest expense for both our continuing and discontinued operations exceeded manufacturer floor plan assistance received by \$10.9 million.

In addition to our variable rate debt, approximately 25% of our dealership facility lease agreements monthly lease payments fluctuate based on LIBOR interest rates. Many of our lease agreements have interest rate floors whereby our lease expense would not fluctuate significantly in periods when LIBOR is relatively low.

In order to reduce our exposure to market risks from fluctuations in interest rates, we had one interest rate swap agreement (the Fixed Swap ) to effectively convert a portion of our LIBOR-based variable rate debt to a fixed rate. The Fixed Swap matured June 6, 2006 and had a notional principal of \$100.0 million. Under the terms of the Fixed Swap, we received interest payments on the notional amount at a rate equal to the one month LIBOR rate, adjusted monthly, and made interest payments at a fixed rate of 4.50%.

We also have five separate interest rate swaps with a total notional amount of \$150.0 million (collectively, the Variable Swaps ) to effectively convert a portion of our fixed rate debt to a LIBOR-based variable rate debt. Under the Variable Swaps agreements, we receive 8.625% on the respective notional amounts and pay interest payments on the respective notional amounts at a rate equal to the forward six month LIBOR (fixed on February 15 and August 15 of each year) plus a spread ranging from 3.825% to 3.85% with a weighted average spread of 3.83%. The Variable Swaps expire on August 15, 2013.

***Foreign Currency Risk***

We purchase certain of our new vehicle and parts inventories from foreign manufacturers. Although we purchase our inventories in U.S. Dollars, our business is subject to foreign exchange rate risk, which may influence automobile manufacturers ability to provide their products at competitive prices in the United States. To the extent this volatility negatively impacts consumer demand through higher retail prices for our products, this volatility could adversely affect our future operating results.

**Item 4: Controls and Procedures.**

Our management, under the supervision and with the participation of our principal executive officer and principal financial officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our principal executive officer and principal financial officer have concluded that the design and operation of our disclosure controls and procedures were effective as of the end of the period covered by this Quarterly Report on Form 10-Q. During our last fiscal quarter, there were no changes in our internal control over financial reporting that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

---

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

**PART II OTHER INFORMATION**

**Item 1: Legal Proceedings.**

Several of our Texas dealership subsidiaries have been named in three class action lawsuits brought against the Texas Automobile Dealers Association ( TADA ) and new vehicle dealerships in Texas that are members of the TADA. Approximately 630 Texas dealerships are named as defendants in two of the actions, and approximately 700 dealerships are named as defendants in the other action. The three six actions allege that since January 1994, Texas automobile dealerships have deceived customers with respect to a vehicle inventory tax and violated federal antitrust and other laws. In April 2002, in two actions, the Texas state court certified two classes of consumers on whose behalf the actions would proceed. The Texas Court of Appeals subsequently affirmed the trial court s order of class certification in the state actions, and the Texas Supreme Court issued an order for the second time in September 2004 stating that it would not hear the merits of the defendant s appeal on class certification. The federal trial court conditionally certified a class of consumers in the federal antitrust case, but on appeal by the defendant dealerships, the U.S. Court of Appeals for the Fifth Circuit reversed the certification of the plaintiff class in October 2004 and remanded the case back to the federal trial court for further proceedings not inconsistent with the Fifth Circuit s ruling. The plaintiffs have appealed this ruling by the Fifth Circuit.

In June 2005, our Texas dealerships and several other dealership defendants entered into a settlement agreement with the plaintiffs in both the state and the federal cases that would settle each of the cases on behalf of our Texas dealerships. The settlements are contingent upon court approval, and the State court has not yet granted final approval of the settlements. The estimated expense of the proposed settlement is not a material amount to Sonic as a whole, and it includes our Texas dealerships issuing coupons for discounts off future vehicle purchases, refunding cash in certain circumstances, and paying attorneys fees and certain costs. Under the terms of the settlements, our Texas dealerships would continue to itemize and pass through to the customer the cost of the inventory tax. If the TADA matters are not settled, our Texas dealership subsidiaries would then vigorously defend themselves and assert available defenses. In addition, we may have rights of indemnification with respect to certain aspects of the TADA matters. However, an adverse resolution of the TADA matters could result in the payment of significant costs and damages and negatively impact our Texas dealerships ability to itemize and pass through to the customer the cost of the vehicle inventory tax in the future, which could have a material adverse effect on our future results of operations, financial condition and cash flows.

We are also a defendant in the matter of *Galura, et al. v. Sonic Automotive, Inc.*, a private civil action filed in the Circuit Court of Hillsborough County, Florida. In this action, originally filed on December 30, 2002, the plaintiffs allege that we and our Florida dealerships sold an antitheft protection product in a deceptive or otherwise illegal manner, and further sought representation on behalf of any customer of any of our Florida dealerships who purchased the antitheft protection product since December 30, 1998. The plaintiffs are seeking monetary damages and injunctive relief on behalf of this class of customers. In June 2005, the court granted the plaintiffs motion for certification of the requested class of customers, but the court has made no finding to date regarding actual liability in this lawsuit. We subsequently filed a notice of appeal of the court s class certification ruling with the Florida Court of Appeals. We intend to continue vigorous defense of this lawsuit, including the appeal of the trial court s class certification order, and to assert available defenses. However, an adverse resolution of this lawsuit could result in the payment of significant costs and damages, which could have a material adverse effect on our future results of operations, financial condition and cash flows.

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

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

**RISK FACTORS**

**Item 1A: Risk Factors**

*Risks Related to Our Indebtedness*

**Our significant indebtedness could materially adversely affect our financial health, limit our ability to finance future acquisitions and capital expenditures and prevent us from fulfilling our financial obligations.**

As of June 30, 2006, our total outstanding indebtedness was \$1,898.2 million, including the following:

\$70.2 million under a revolving credit facility;

\$1,250.6 million under standardized secured new and used inventory floor plan facilities, including \$150.7 million classified as liabilities associated with assets held for sale;

\$128.3 million in 5.25% convertible senior subordinated notes due 2009 (the 5.25% Convertibles ) representing \$130.1 million in aggregate principal amount outstanding less unamortized discount of approximately \$1.8 million;

\$156.4 million in 4.25% convertible senior subordinated notes due 2015, redeemable on or after November 30, 2010, (the 4.25% Convertibles ) representing \$160.0 million in aggregate principal amount outstanding less unamortized discount of approximately \$3.6 million;

\$272.4 million in 8.625% senior subordinated notes due 2013 (the 8.625% Notes ) representing \$275.0 million in aggregate principal amount outstanding less unamortized net discount of approximately \$2.6 million; and

\$20.3 million of other secured debt, representing \$24.1 million in aggregate principal amount plus unamortized premium of approximately \$5.3 million and less \$9.1 million for the fair value of fixed to variable interest rate swaps.

As of June 30, 2006, we had \$204.1 million available for additional borrowings under a revolving credit facility. We also had \$100.0 million available under a construction/mortgage credit facility for real estate acquisitions and new dealership construction. We also have significant additional capacity under the new and used floor plan facilities. In addition, the indentures relating to our 8.625% Notes, 5.25% Convertibles, 4.25% Convertibles and other debt instruments allow us to incur additional indebtedness, including secured indebtedness. Our revolving facility, up to \$700.0 million in borrowing availability for new vehicle inventory floor plan financing and up to \$150.0 million in borrowing availability for used vehicle inventory floor plan financing are collectively referred to as our 2006 Credit Facility .

The degree to which we are leveraged could have important consequences to the holders of our securities, including the following:

our ability to obtain additional financing for acquisitions, capital expenditures, working capital or general corporate purposes may be impaired in the future;

## Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

a substantial portion of our current cash flow from operations must be dedicated to the payment of principal and interest on our indebtedness, thereby reducing the funds available to us for our operations and other purposes;

some of our borrowings are and will continue to be at variable rates of interest, which exposes us to the risk of increasing interest rates;

the indebtedness outstanding under our revolving credit facility and floor plan facilities are secured by a pledge of substantially all the assets of our dealerships; and

we may be substantially more leveraged than some of our competitors, which may place us at a relative competitive disadvantage and make us more vulnerable to changing market conditions and regulations.

In addition, our debt agreements contain numerous covenants that limit our discretion with respect to business matters, including mergers or acquisitions, paying dividends, incurring additional debt, making capital expenditures or disposing of assets.

---

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

**RISK FACTORS**

**An acceleration of our obligation to repay all or a substantial portion of our outstanding indebtedness would have a material adverse effect on our business, financial condition or results of operations.**

Our revolving credit facility, new and used floor plan facilities and the indenture governing our 8.625% Notes contain numerous financial and operating covenants. A breach of any of these covenants could result in a default under the applicable agreement or indenture. If a default were to occur, we may be unable to adequately finance our operations and the value of our common stock would be materially adversely affected. In addition, a default under one agreement or indenture could result in a default and acceleration of our repayment obligations under the other agreements or indentures, including the indentures governing our outstanding 5.25% Convertibles, 4.25% Convertibles and our 8.625% Notes, under the cross default provisions in those agreements or indentures. If a cross default were to occur, we may not be able to pay our debts or borrow sufficient funds to refinance them. Even if new financing were available, it may not be on terms acceptable to us. As a result of this risk, we could be forced to take actions that we otherwise would not take, or not take actions that we otherwise might take, in order to comply with the covenants in these agreements and indentures.

**Our ability to make interest and principal payments when due to holders of our debt securities depends upon the receipt of sufficient funds from our subsidiaries.**

Substantially all of our consolidated assets are held by our subsidiaries and substantially all of our consolidated cash flow and net income are generated by our subsidiaries. Accordingly, our cash flow and ability to service debt depends to a substantial degree on the results of operations of subsidiaries and upon the ability of our subsidiaries to provide us with cash. We may receive cash from our subsidiaries in the form of dividends, loans or otherwise. We may use this cash to service our debt obligations or for working capital. Our subsidiaries are separate and distinct legal entities and have no obligation, contingent or otherwise, to distribute cash to us or to make funds available to service debt. In addition, the ability of our subsidiaries to pay dividends or make loans to us are subject to contractual limitations under the floor plan facilities, minimum net capital requirements under manufacturer franchise agreements and laws of the state in which a subsidiary is organized and depend to a significant degree on the results of operations of our subsidiaries and other business considerations.

*Risks Related to Our Relationships with Vehicle Manufacturers*

**Our operations may be adversely affected if one or more of our manufacturer franchise agreements is terminated or not renewed.**

Each of our dealerships operates under a franchise agreement with the applicable automobile manufacturer or distributor. Without a franchise agreement, we cannot obtain new vehicles from a manufacturer. As a result, we are significantly dependent on our relationships with these manufacturers.

Manufacturers exercise a great degree of control over the operations of our dealerships through the franchise agreements. The franchise agreements govern, among other things, our ability to purchase vehicles from the manufacturer and to sell vehicles to customers. Each of our franchise agreements provides for termination or non-renewal for a variety of causes, including any unapproved change of ownership or management. Manufacturers may also have a right of first refusal if we seek to sell dealerships.

Actions taken by manufacturers to exploit their superior bargaining position in negotiating the terms of franchise agreements or renewals of these agreements or otherwise could also have a material adverse effect on our results of operations, financial condition and cash flows. We cannot assure you that any of our existing franchise agreements will be renewed or that the terms and conditions of such renewals will be favorable to us.

**Our sales volume and profit margin on each sale may be materially adversely affected if manufacturers discontinue or change their incentive programs.**

Our dealerships depend on the manufacturers for certain sales incentives, warranties and other programs that are intended to promote and support dealership new vehicle sales. Manufacturers routinely modify their incentive programs in response to changing market conditions. Some of the key incentive programs include:

customer rebates or below market financing on new vehicles;

employee pricing;

dealer incentives on new vehicles;

warranties on new and used vehicles; and

sponsorship of used vehicle sales by authorized new vehicle dealers.

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

**RISK FACTORS**

Manufacturers are currently offering very favorable incentives to potential customers. A reduction or discontinuation of a manufacturer's incentive programs may materially adversely affect our profitability.

**We depend on manufacturers to supply us with sufficient numbers of popular and profitable new models.**

Manufacturers typically allocate their vehicles among dealerships based on the sales history of each dealership. Supplies of popular new vehicles may be limited by the applicable manufacturer's production capabilities. Popular new vehicles that are in limited supply typically produce the highest profit margins. We depend on manufacturers to provide us with a desirable mix of popular new vehicles. Our operating results may be materially adversely affected if we do not obtain a sufficient supply of these vehicles.

**Adverse conditions affecting one or more key manufacturers may negatively impact our profitability.**

During the three and six month periods ended June 30, 2006, approximately 76.5% and 76.3% of our new vehicle revenue was derived from the sale of new vehicles manufactured by Ford, Honda, General Motors (including Cadillac), BMW, Mercedes and Toyota. Our success depends to a great extent on these manufacturers :

financial condition;

marketing;

vehicle design;

publicity concerning a particular manufacturer or vehicle model;

production capabilities;

management;

reputation; and

labor relations.

Events such as labor strikes that may adversely affect a manufacturer may also adversely affect us. In particular, labor strikes at a manufacturer that continue for a substantial period of time could have a material adverse effect on our business. Similarly, the delivery of vehicles from manufacturers at a time later than scheduled, which may occur particularly during periods of new product introductions, could limit sales of those vehicles during those periods. This has been experienced at some of our dealerships from time to time. Adverse conditions affecting these and other important aspects of manufacturers' operations and public relations may adversely affect our ability to sell their automobiles and, as a result, significantly and detrimentally affect our profitability.

## Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

During 2005 and into 2006, the financial condition and operating results of both Ford and General Motors has deteriorated significantly. As of June 30, 2006, we owned 25 Ford owned franchises (including Volvo, Land Rover, Lincoln and Mercury) and 41 General Motors owned franchises (including Cadillac, Saab, Saturn, Chevrolet, Buick, GMC, Hummer and Pontiac), respectively. Should the financial condition and operating results of either Ford or General Motors continue to significantly deteriorate, it is possible that the particular manufacturer could file for bankruptcy protection. Such a bankruptcy filing by either Ford or General Motors could have a material adverse effect on our future results of operation, financial condition or cash flows.

### **Manufacturer stock ownership restrictions may impair our ability to maintain or renew franchise agreements or issue additional equity.**

Some of our franchise agreements prohibit transfers of any ownership interests of a dealership and, in some cases, its parent, without prior approval of the applicable manufacturer. A number of manufacturers impose restrictions on the transferability of our Class A common stock and our ability to maintain franchises if a person acquires a significant percentage of the voting power of our common stock. Our existing franchise agreements could be terminated if a person or entity acquires a substantial ownership interest in us or acquires voting power above certain levels without the applicable manufacturer's approval. Violations of these levels by an investor are generally outside of our control and may result in the termination or non-renewal of existing franchise agreements or impair our ability to negotiate new franchise agreements for dealerships we acquire. In addition, if we cannot obtain any requisite approvals on a timely basis, we may not be able to issue additional equity or otherwise raise capital on terms acceptable to us. These restrictions may also prevent or deter a prospective acquiror from acquiring control of us. This could adversely affect the market price of our Class A common stock.



---

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

**RISK FACTORS**

The current holders of our Class B common stock maintain voting control over us. However, we are unable to prevent our stockholders from transferring shares of our common stock, including transfers by holders of the Class B common stock. If such transfer results in a change in control, it could result in the termination or non-renewal of one or more of our existing franchise agreements, the triggering of provisions in our agreements with certain manufacturers requiring us to sell our dealerships franchised with such manufacturers and/or a default under our credit arrangements.

**Our dealers depend upon vehicle sales and, therefore, their success depends in large part upon customer demand for the particular vehicles they carry.**

The success of our dealerships depends in large part on the overall success of the vehicle lines they carry. New vehicle sales generate the majority of our total revenue and lead to sales of higher-margin products and services such as finance, insurance, vehicle protection products and other aftermarket products, and parts and service operations. Although we have sought to limit our dependence on any one vehicle brand and our parts and service operations and used vehicle sales may serve to offset some of this risk, we have focused our new vehicle sales operations in mid-line import and luxury brands.

**Our failure to meet a manufacturer's consumer satisfaction, financial and sales performance requirements may adversely affect our ability to acquire new dealerships and our profitability.**

Many manufacturers attempt to measure customers' satisfaction with their sales and warranty service experiences through manufacturer-determined consumer satisfaction index (CSI) scores. The components of CSI vary from manufacturer to manufacturer and are modified periodically. Franchise agreements also may impose financial and sales performance standards. Under our agreements with certain manufacturers, a dealership's CSI scores, sales and financial performance may be considered a factor in evaluating applications for additional dealership acquisitions. From time to time, some of our dealerships have had difficulty meeting various manufacturers' CSI requirements or performance standards. We cannot assure you that our dealerships will be able to comply with these requirements in the future. A manufacturer may refuse to consent to an acquisition of one of its franchises if it determines our dealerships do not comply with its CSI requirements or performance standards, which could impair the execution of our acquisition strategy. In addition, we receive incentive payments from the manufacturers based, in part, on CSI scores, which could be materially adversely affected if our CSI scores decline.

**If state dealer laws are repealed or weakened, our dealerships will be more susceptible to termination, non-renewal or renegotiation of their franchise agreements.**

State dealer laws generally provide that a manufacturer may not terminate or refuse to renew a franchise agreement unless it has first provided the dealer with written notice setting forth good cause and stating the grounds for termination or nonrenewal. Some state dealer laws allow dealers to file protests or petitions or attempt to comply with the manufacturer's criteria within the notice period to avoid the termination or nonrenewal. Though unsuccessful to date, manufacturers' lobbying efforts may lead to the repeal or revision of state dealer laws. If dealer laws are repealed in the states in which we operate, manufacturers may be able to terminate our franchises without providing advance notice, an opportunity to cure or a showing of good cause. Without the protection of state dealer laws, it may also be more difficult for our dealers to renew their franchise agreements upon expiration.

In addition, these laws restrict the ability of automobile manufacturers to directly enter the retail market in the future. However, the ability of a manufacturer to grant additional franchises is based on several factors which are not within our control. If manufacturers grant new franchises in areas near or within our existing markets, this could significantly impact our revenues and/or profitability. Further, if manufacturers obtain the ability to directly retail vehicles and do so in our markets, such competition could have a material adverse effect on us.

*Risks Related to Our Acquisition Strategy*

**Manufacturers' restrictions on acquisitions could limit our future growth.**

We are required to obtain the approval of the applicable manufacturer before we can acquire an additional dealership franchise of that manufacturer. In determining whether to approve an acquisition, manufacturers may consider many factors such as our financial condition and

## Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

CSI scores. Obtaining manufacturer approval of acquisitions also takes a significant amount of time, typically three to five months. We cannot assure you that manufacturers will approve future acquisitions or do so on a timely basis, which could impair the execution of our acquisition strategy.

Certain manufacturers also limit the number of its dealerships that we may own, our national market share of that manufacturer's products or the number of dealerships we may own in a particular geographic area. In addition, under an applicable franchise agreement or under state law, a manufacturer may have a right of first refusal to acquire a dealership that we seek to acquire.

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

**RISK FACTORS**

A manufacturer may condition approval of an acquisition on the implementation of material changes in our operations or extraordinary corporate transactions, facilities improvements or other capital expenditures. If we are unable or unwilling to comply with these conditions, we may be required to sell the assets of that manufacturer's dealerships or terminate our franchise agreement.

**Failure to effectively integrate acquired dealerships with our existing operations could adversely affect our future operating results.**

Our future operating results depend on our ability to integrate the operations of recently acquired dealerships, as well as dealerships we acquire in the future, with our existing operations. In particular, we need to integrate our management information systems, procedures and organizational structures, which can be difficult. Our growth strategy has focused on the pursuit of strategic acquisitions that either expand or complement our business.

We cannot assure you that we will effectively and profitably integrate the operations of these dealerships without substantial costs, delays or operational or financial problems, due to:

the difficulties of managing operations located in geographic areas where we have not previously operated;

the management time and attention required to integrate and manage newly acquired dealerships;

the difficulties of assimilating and retaining employees; and

the challenges of keeping customers.

These factors could have a material adverse effect on our financial condition and results of operations.

**We may not adequately anticipate all of the demands that growth through acquisitions will impose.**

The automobile retailing industry is considered a mature industry in which minimal growth is expected in total unit sales. Accordingly, our ability to generate higher revenue and earnings in future periods depends in large part on our ability to acquire additional dealerships, manage geographic expansion, control costs in our operations and consolidate both past and future dealership acquisitions into our existing operations. In pursuing a strategy of acquiring other dealerships, we face risks commonly encountered with growth through acquisitions. These risks include, but are not limited to:

incurring significantly higher capital expenditures and operating expenses;

failing to assimilate the operations and personnel of acquired dealerships;

entering new markets with which we are unfamiliar;

## Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

potential undiscovered liabilities and operational difficulties at acquired dealerships;

disrupting our ongoing business;

diverting our management resources;

failing to maintain uniform standards, controls and policies;

impairing relationships with employees, manufacturers and customers as a result of changes in management;

increased expenses for accounting and computer systems, as well as integration difficulties;

failure to obtain a manufacturer's consent to the acquisition of one or more of its dealership franchises or renew the franchise agreement on terms acceptable to us; and

incorrectly valuing entities to be acquired.

We may not adequately anticipate all of the demands that growth will impose on our systems, procedures and structures.

**We may not be able to capitalize on acquisition opportunities because our financial resources available for acquisitions are limited.**

We intend to finance our acquisitions with cash generated from operations, through issuances of our stock or debt securities and through borrowings under credit arrangements. We may not be able to obtain additional financing by issuing stock or debt securities

---

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

**RISK FACTORS**

due to the market price of our Class A common stock, overall market conditions or the need for manufacturer consent to the issuance of equity securities. Using cash to complete acquisitions could substantially limit our operating or financial flexibility. If we are unable to obtain financing on acceptable terms, we may be required to reduce the scope of our presently anticipated expansion, which could materially adversely affect our overall growth strategy.

In addition, we are dependent to a significant extent on our ability to finance our new vehicle inventory with floor plan financing. Floor plan financing arrangements allow us to borrow money to buy a particular vehicle from the manufacturer and pay off the loan when we sell that particular vehicle. We must obtain new floor plan financing or obtain consents to assume existing floor plan financing in connection with our acquisition of dealerships.

Substantially all the assets of our dealerships are pledged to secure the indebtedness under the 2006 Credit Facility and our separate floor plan indebtedness with the respective captive finance subsidiaries of BMW, DaimlerChrysler, Ford and General Motors. Three of the lenders under the 2006 Credit Facility are the respective captive finance subsidiaries of BMW, Nissan and Toyota. These pledges may impede our ability to borrow from other sources. Moreover, because the identified manufacturer captive finance subsidiaries are either owned or affiliated with BMW, DaimlerChrysler, Ford, General Motors, Nissan and Toyota, respectively, any deterioration of our relationship with the particular captive finance subsidiary could adversely affect our relationship with the affiliated manufacturer, and vice-versa.

**We may not be able to continue executing our acquisition strategy without the costs of future acquisitions escalating.**

We have grown our business primarily through acquisitions. We may not be able to consummate any future acquisitions at acceptable prices and terms or identify suitable candidates. In addition, increased competition for acquisition candidates could result in fewer acquisition opportunities for us and higher acquisition prices. The magnitude, timing, pricing and nature of future acquisitions will depend upon various factors, including:

the availability of suitable acquisition candidates;

competition with other dealer groups for suitable acquisitions;

the negotiation of acceptable terms;

our financial capabilities;

our stock price; and

the availability of skilled employees to manage the acquired companies.

**We may not be able to determine the actual financial condition of dealerships we acquire until after we complete the acquisition and take control of the dealerships.**

The operating and financial condition of acquired businesses cannot be determined accurately until we assume control. Although we conduct what we believe to be a prudent level of investigation regarding the operating and financial condition of the businesses we purchase, in light of the circumstances of each transaction, an unavoidable level of risk remains regarding the actual operating condition of these businesses.

Similarly, many of the dealerships we acquire, including our largest acquisitions, do not have financial statements audited or prepared in accordance with generally accepted accounting principles. We may not have an accurate understanding of the historical financial condition and performance of our acquired entities. Until we actually assume control of business assets and their operations, we may not be able to ascertain the actual value or understand the potential liabilities of the acquired entities and their operations.

**Although O. Bruton Smith, our chairman and chief executive officer, and his affiliates have previously assisted us with obtaining financing, we cannot assure you that he will be willing or able to do so in the future.**

Our obligations under the 2006 Credit Facility are secured with a pledge of shares of common stock of Speedway Motorsports, Inc., a publicly traded owner and operator of automobile racing facilities. These shares of Speedway Motorsports common stock are beneficially owned by Sonic Financial Corporation ( SFC ), an entity controlled by Mr. Smith. Presently, the \$350.0 million borrowing limit of our revolving credit facility is subject to a borrowing base calculation that is based, in part, on the value of the Speedway Motorsports shares pledged by SFC. Consequently, a withdrawal of this pledge by SFC or a significant decrease in the value of Speedway Motorsports common stock could reduce the amount we can borrow under the revolving credit facility.

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

**RISK FACTORS**

Mr. Smith has also guaranteed additional indebtedness incurred to complete certain dealership acquisitions. Mr. Smith may not be willing or able to provide similar guarantees or credit support in the future. This could impair our ability to obtain acquisition financing on favorable terms.

*Risks Related to the Automotive Retail Industry*

**Increasing competition among automotive retailers reduces our profit margins on vehicle sales and related businesses. Further, the use of the Internet in the car purchasing process could materially adversely affect us.**

Automobile retailing is a highly competitive business. Our competitors include publicly and privately owned dealerships, some of which are larger and have greater financial and marketing resources than we do. Many of our competitors sell the same or similar makes of new and used vehicles that we offer in our markets at competitive prices. We do not have any cost advantage in purchasing new vehicles from manufacturers due to economies of scale or otherwise. In addition, the popularity of short-term vehicle leasing in the past few years has resulted, as these leases expire, in a large increase in the number of late model used vehicles available in the market, which puts added pressure on new and used vehicle margins. We typically rely on advertising, merchandising, sales expertise, service reputation and dealership location to sell new vehicles. Our revenues and profitability could be materially adversely affected if manufacturers decide to enter the retail market directly.

Our financing, insurance, vehicle protection product and other aftermarket product ( F&I ) business and other related businesses, which have higher margins than sales of new and used vehicles, are subject to strong competition from various financial institutions and other third parties.

The Internet has become a significant part of the sales process in our industry. Customers are using the Internet to compare pricing for cars and related F&I services, which may further reduce margins for new and used cars and profits for related F&I services. If Internet new vehicle sales are allowed to be conducted without the involvement of franchised dealers, our business could be materially adversely affected. In addition, other franchise groups have aligned themselves with services offered on the Internet or are investing heavily in the development of their own Internet capabilities, which could materially adversely affect our business.

Our franchise agreements do not grant us the exclusive right to sell a manufacturer's product within a given geographic area. Our revenues or profitability could be materially adversely affected if any of our manufacturers award franchises to others in the same markets where we operate or if existing franchised dealers increase their market share in our markets.

As we seek to acquire dealerships in new markets, we may face increasingly significant competition as we strive to gain market share through acquisitions or otherwise. Our gross margins may decline over time as we expand into markets where we do not have a leading position.

**Our business will be harmed if overall consumer demand suffers from a severe or sustained downturn.**

Our business is heavily dependent on consumer demand and preferences. Our revenues will be materially and adversely affected if there is a severe or sustained downturn in overall levels of consumer spending. Retail vehicle sales are cyclical and historically have experienced periodic downturns characterized by oversupply and weak demand. These cycles are often dependent on general economic conditions and consumer confidence, as well as the level of discretionary personal income and credit availability. Future recessions may have a material adverse effect on our retail business, particularly sales of new and used automobiles. In addition, severe or sustained increases in gasoline prices may lead to a reduction in automobile purchases or a shift in buying patterns from luxury and sport utility vehicle models (which typically provide high margins to retailers) to smaller, more economical vehicles (which typically have lower margins).

**A decline of available financing in the sub-prime lending market has, and may continue to, adversely affect our sales of used vehicles.**

A significant portion of vehicle buyers, particularly in the used car market, finance their purchases of automobiles. Sub-prime lenders have historically provided financing for consumers who, for a variety of reasons including poor credit histories and lack of down payment, do not have access to more traditional finance sources. Our recent experience suggests that sub-prime lenders have tightened their credit standards and may continue to apply these higher standards in the future. This has adversely affected our used vehicle sales. If sub-prime lenders continue to apply these higher standards or if there is any further tightening of credit standards used by sub-prime lenders or if there is any additional decline

## Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

in the overall availability of credit in the sub-prime lending market, the ability of these consumers to purchase vehicles could be limited which could have a material adverse effect on our used car business, revenues and profitability.



**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

**RISK FACTORS**

**Our business may be adversely affected by import product restrictions and foreign trade risks that may impair our ability to sell foreign vehicles profitably.**

A significant portion of our new vehicle business involves the sale of vehicles, parts or vehicles composed of parts that are manufactured outside the United States. As a result, our operations are subject to customary risks of importing merchandise, including fluctuations in the relative values of currencies, import duties, exchange controls, trade restrictions, work stoppages and general political and socio-economic conditions in other countries. The United States or the countries from which our products are imported may, from time to time, impose new quotas, duties, tariffs or other restrictions, or adjust presently prevailing quotas, duties or tariffs, which may affect our operations and our ability to purchase imported vehicles and/or parts at reasonable prices.

**The seasonality of our business magnifies the importance of second and third quarter operating results.**

Our business is subject to seasonal variations in revenues. In our experience, demand for automobiles is generally lower during the first and fourth quarters of each year. We therefore receive a disproportionate amount of revenues generally in the second and third quarters and expect our revenues and operating results to be generally lower in the first and fourth quarters. Consequently, if conditions surface during the second and third quarters that impair vehicle sales, such as higher fuel costs, depressed economic conditions or similar adverse conditions, our revenues for the year could be disproportionately adversely affected.

*General Risks Related to Investing in Our Securities*

**Concentration of voting power and anti-takeover provisions of our charter, bylaws, Delaware law and our dealer agreements may reduce the likelihood of any potential change of control.**

Our common stock is divided into two classes with different voting rights. This dual class stock ownership allows the present holders of the Class B common stock to control us. Holders of Class A common stock have one vote per share on all matters. Holders of Class B common stock have 10 votes per share on all matters, except that they have only one vote per share on any transaction proposed or approved by the Board of Directors or a Class B common stockholder or otherwise benefiting the Class B common stockholders constituting a:

going private transaction;

disposition of substantially all of our assets;

transfer resulting in a change in the nature of our business; or

merger or consolidation in which current holders of common stock would own less than 50% of the common stock following such transaction.

The holders of Class B common stock currently hold less than a majority of our outstanding common stock, but a majority of our voting power. This may prevent or discourage a change of control of us even if the action was favored by holders of Class A common stock.

Our charter and bylaws make it more difficult for our stockholders to take corporate actions at stockholders' meetings. In addition, options under our 1997 Stock Option Plan and 2004 Stock Incentive Plan become immediately exercisable upon a change in control. Delaware law also makes it difficult for stockholders who have recently acquired a large interest in a company to consummate a business combination transaction with the company against its directors' wishes. Finally, restrictions imposed by our dealer agreements may impede or prevent any potential takeover bid.

## Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

Generally, our franchise agreements allow the manufacturers the right to terminate the agreements upon a change of control of our company and impose restrictions upon the transferability of any significant percentage of our stock to any one person or entity who may be unqualified, as defined by the manufacturer, to own one of its dealerships. The inability of a person or entity to qualify with one or more of our manufacturers may prevent or seriously impede a potential takeover bid. In addition, provisions of our lending arrangements create an event of default on a change in control. These agreements, corporate governance documents and laws may have the effect of delaying or preventing a change in control or preventing stockholders from realizing a premium on the sale of their shares if we were acquired.

**The outcome of legal and administrative proceedings we are or may become involved in could have an adverse effect on our business, results of operations and profitability.**

We are involved, and expect to continue to be involved, in numerous legal and administrative proceedings arising out of the conduct of our business, including regulatory investigations and private civil actions brought by plaintiffs purporting to represent a potential class or for which a class has been certified, such as the following.

---

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

**RISK FACTORS**

Several private civil actions have been filed against Sonic Automotive, Inc. and several of our dealership subsidiaries that purport to represent classes of customers as potential plaintiffs and make allegations that certain products sold in the finance and insurance departments were done so in a deceptive or otherwise illegal manner. One of these private civil actions has been filed in South Carolina state court against Sonic Automotive, Inc. and 10 of our South Carolina subsidiaries. We have been advised that the plaintiffs' attorneys in this South Carolina private civil action intend to file private civil class actions against Sonic Automotive, Inc. and certain of its subsidiaries in other states. This group of plaintiffs' attorneys has filed another one of these private civil class action lawsuits in state court in North Carolina seeking certification of a multi-state class of plaintiffs. The South Carolina state court action and the North Carolina state court action have since been consolidated into a single proceeding in private arbitration. Another one of these private civil actions has been filed in Tennessee state court against Sonic Automotive, Inc. and one of our Tennessee subsidiaries. Additionally, a private civil action has also been filed against one of our dealerships in Los Angeles County stating allegations of deceptive sales practices by that dealership. The plaintiffs in this private civil action purport to represent a class of customers as potential plaintiffs, although no motion for class certification has been filed.

The outcomes of the civil actions brought by plaintiffs purporting to represent a class of customers, as well as other pending and future legal proceedings arising out of the conduct of our business, including litigation with customers, employment related lawsuits, contractual disputes, class actions, purported class actions and actions brought by governmental authorities, cannot be predicted with certainty. An unfavorable resolution of one or more of these matters could have a material adverse effect on our business, financial condition, results of operations, cash flows or prospects.

In addition, several of our Texas dealership subsidiaries have been named in three class action lawsuits brought against the Texas Automobile Dealers Association ( TADA ) and new vehicle dealerships in Texas that are members of the TADA. Approximately 630 Texas dealerships are named as defendants in two of the actions, and approximately 700 Texas dealerships are named as defendants in the other action. The three actions allege that since January 1994, Texas automobile dealerships have deceived customers with respect to a vehicle inventory tax and violated federal antitrust and other laws. In April 2002, in two actions the Texas state court certified two classes of consumers on whose behalf the actions would proceed. The Texas Court of Appeals subsequently affirmed the trial court's order of class certification in the state actions, and the Texas Supreme Court issued an order for the second time in September 2004 stating that it would not hear the merits of the defendant's appeal on class certification. The federal trial court conditionally certified a class of consumers in the federal antitrust case, but on appeal by the defendant dealerships, the U.S. Court of Appeals for the Fifth Circuit reversed the certification of the plaintiff class in October 2004 and remanded the case back to the federal trial court for further proceedings not inconsistent with the Fifth Circuit's ruling. The plaintiffs have appealed this ruling by the Fifth Circuit.

In June 2005, our Texas dealerships and several other dealership defendants entered into a settlement agreement with the plaintiffs in both the state and the federal cases that would settle each of the cases on behalf of our Texas dealerships. The settlements are contingent upon court approval, and the state court has not yet granted final approval of the settlements. If the TADA matters are not settled, our Texas dealership subsidiaries would then vigorously defend themselves and assert available defenses. In addition, we may have rights of indemnification with respect to certain aspects of the TADA matters. However, an adverse resolution of the TADA matters could result in the payment of significant costs and damages and negatively impact our Texas dealerships' ability to itemize and pass through to the customer the cost of the vehicle inventory tax in the future, which could have a material adverse effect on our future results of operations, financial condition and cash flows.

Our company is also a defendant in the matter of *Galura, et al. v. Sonic Automotive, Inc.*, a private civil action filed in the Circuit Court of Hillsborough County, Florida. In this action, originally filed on December 30, 2002, the plaintiffs allege that we and our Florida dealerships sold an anti-theft protection product in a deceptive or otherwise illegal manner, and further sought representation on behalf of any customer of any of our Florida dealerships who purchased the anti-theft protection product since December 30, 1998. The plaintiffs are seeking monetary damages and injunctive relief on behalf of this class of customers. In June 2005, the court granted the plaintiffs' motion for certification of the requested class of customers, but the court has made no finding to date regarding actual liability in this lawsuit. We have subsequently filed a notice of appeal of the court's class certification ruling with the Florida Court of Appeals. We intend to continue our vigorous defense of this lawsuit, including the aforementioned appeal of the trial court's class certification order, and to assert available defenses. However, an adverse resolution of this lawsuit could result in the payment of significant costs and damages, which could have a material adverse effect on our future results of operations, financial condition and cash flows.



---

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

**RISK FACTORS**

**Our business may be adversely affected by claims alleging violations of laws and regulations in our advertising, sales and finance and insurance activities.**

Our business is highly regulated. In the past several years, private plaintiffs and state attorney generals have increased their scrutiny of advertising, sales, and finance and insurance activities in the sale and leasing of motor vehicles. The conduct of our business is subject to numerous federal, state and local laws and regulations regarding unfair, deceptive and/or fraudulent trade practices (including advertising, marketing, sales, insurance, repair and promotion practices), truth-in-lending, consumer leasing, fair credit practices, equal credit opportunity, privacy, insurance, motor vehicle finance, installment finance, closed-end credit, usury and other installment sales. Claims arising out of actual or alleged violations of law may be asserted against us or any of our dealers by individuals, either individually or through class actions, or by governmental entities in civil or criminal investigations and proceedings. Such actions may expose us to substantial monetary damages and legal defense costs, injunctive relief and criminal and civil fines and penalties, including suspension or revocation of our licenses and franchises to conduct dealership operations.

**Our business may be adversely affected by unfavorable conditions in our local markets, even if those conditions are not prominent nationally.**

Our performance is subject to local economic, competitive, weather and other conditions prevailing in geographic areas where we operate. For example, our current results of operations depend substantially on general economic conditions and consumer spending habits in our Northern California and Houston markets. Revenues in our Northern California and Houston markets represented approximately 16.7% and 16.2%, respectively, of our total revenues for the three and six month periods ended June 30, 2006. We may not be able to expand geographically and any geographic expansion may not adequately insulate us from the adverse effects of local or regional economic conditions.

**The loss of key personnel and limited management and personnel resources could adversely affect our operations and growth.**

Our success depends to a significant degree upon the continued contributions of our management team, particularly our senior management, and service and sales personnel. Additionally, manufacturer franchise agreements may require the prior approval of the applicable manufacturer before any change is made in franchise general managers. We do not have employment agreements with certain members of our senior management team, our dealership managers and other key dealership personnel. Consequently, the loss of the services of one or more of these key employees could have a material adverse effect on our results of operations.

In addition, as we expand we may need to hire additional managers. The market for qualified employees in the industry and in the regions in which we operate, particularly for general managers and sales and service personnel, is highly competitive and may subject us to increased labor costs during periods of low unemployment. The loss of the services of key employees or the inability to attract additional qualified managers could have a material adverse effect on our results of operations. In addition, the lack of qualified management or employees employed by potential acquisition candidates may limit our ability to consummate future acquisitions.

**Governmental regulation and environmental regulation compliance costs may adversely affect our profitability.**

We are subject to a wide range of federal, state and local laws and regulations, such as local licensing requirements, retail financing and consumer protection laws and regulations, and wage-hour, anti-discrimination and other employment practices laws and regulations. Our facilities and operations are also subject to federal, state and local laws and regulations relating to environmental protection and human health and safety, including those governing wastewater discharges, air emissions, the operation and removal of underground and aboveground storage tanks, the use, storage, treatment, transportation, release, recycling and disposal of solid and hazardous materials and wastes and the cleanup of contaminated property or water. The violation of these laws and regulations can result in administrative, civil or criminal penalties against us or in a cease and desist order against our operations that are not in compliance. Our future acquisitions may also be subject to regulation, including antitrust reviews. We believe that we comply in all material respects with all laws and regulations applicable to our business, but future regulations may be more stringent and require us to incur significant additional compliance costs.

Our past and present business operations are subject to environmental laws and regulations. We may be required by these laws to pay the full amount of the costs of investigation and/or remediation of contaminated properties, even if we are not at fault for disposal of the materials or if

## Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

such disposal was legal at the time. Like many of our competitors, we have incurred, and will continue to incur, capital and operating expenditures and other costs in complying with these laws and regulations. In addition, soil and groundwater contamination exists at certain of our properties. We cannot assure you that our other properties have not been or will not become similarly contaminated. In addition, we could become subject to potentially material new or unforeseen environmental costs or liabilities because of our acquisitions.

---

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

**RISK FACTORS**

**Potential conflicts of interest between us and our officers or directors could adversely affect our future performance.**

O. Bruton Smith serves as the chairman and chief executive officer of Speedway Motorsports. Accordingly, we compete with Speedway Motorsports for the management time of Mr. Smith.

We have in the past and will likely in the future enter into transactions with Mr. Smith, entities controlled by Mr. Smith or our other affiliates. We believe that all of our existing arrangements with affiliates are as favorable to us as if the arrangements were negotiated between unaffiliated parties, although the majority of these transactions have neither been verified by third parties in that regard nor are likely to be so verified in the future. Potential conflicts of interest could arise in the future between us and our officers or directors in the enforcement, amendment or termination of arrangements existing between them.

**We may be subject to substantial withdrawal liability assessments in the future related to a multi-employer pension plan to which certain of our dealerships make contributions pursuant to collective bargaining agreements.**

Seven of our dealership subsidiaries in Northern California currently make fixed-dollar contributions to the Automotive Industries Pension Plan pursuant to collective bargaining agreements between our subsidiaries and the International Association of Machinists. The AI Pension Plan is a multi-employer pension plan as defined under the Employee Retirement Income Security Act of 1974, as amended, and our seven dealership subsidiaries are among approximately 120 automobile dealerships that make contributions to the AI Pension Plan pursuant to collective bargaining agreements with the IAM. In June 2006, we received information that the AI Pension Plan was substantially underfunded as of December 31, 2005. Under applicable federal law, any employer contributing to a multiemployer pension plan that completely ceases participating in the plan while the plan is underfunded is subject to payment of such employer's assessed share of the aggregate unfunded vested benefits of the plan. In certain circumstances, an employer can be assessed withdrawal liability for a partial withdrawal from a multi-employer pension plan. In addition, if the financial condition of the AI Pension Plan were to continue to deteriorate to the point that the Plan is forced to terminate and be assumed by the Pension Benefit Guaranty Corporation, the participating employers could be subject to assessments by the PBGC to cover the participating employers' assessed share of the unfunded vested benefits. If any of these adverse events were to occur in the future, it could result in a substantial withdrawal liability assessment that could have a material adverse effect on our business, financial condition, results of operations or cash flows.

**A change in historical experience and/or assumptions used to estimate reserves could have a material impact on our earnings.**

As described in Item 7 under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations - Use of Estimates and Critical Accounting Policies" in our Annual Report on Form 10-K for the year ended December 31, 2005, our estimates for finance, insurance and service contracts, insurance reserves and Cornerstone Acceptance allowance for credit losses is based on historical experience and our assumptions based on this historical experience. Differences between actual results and our historical experiences and/or our assumptions could have a material impact on our earnings in the period of the change and in periods subsequent to the change.

**An impairment of our goodwill could have a material adverse impact on our earnings.**

Pursuant to applicable accounting pronouncements, we test goodwill for impairment annually or more frequently if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. We describe the process for testing goodwill more thoroughly in our Annual Report on Form 10-K for the year ended December 31, 2005 in Item 7 under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations - Use of Estimates and Critical Accounting Policies." If we determine that the amount of our goodwill is impaired at any point in time, we will be required to reduce goodwill on our balance sheet. A reduction in the amount of goodwill on our balance sheet will require us to record a non-cash impairment charge against our earnings for the period in which the impairment of goodwill occurred. This would have a material adverse impact on our earnings for that period.

Poor performance in one or more of our geographic divisions or a realignment of the dealerships which comprise each division could constitute events or changes in circumstances for purposes of determining whether the fair value of our goodwill has been reduced below the carrying amount. We would therefore be required to test our goodwill for impairment. As of June 30, 2006, our balance sheet reflected a carrying amount of approximately \$1,175.6 million in goodwill (including goodwill classified as assets held for sale), which was allocated between three

## Edgar Filing: SONIC AUTOMOTIVE INC - Form 10-Q

geographic reporting units. If the goodwill in any of our reporting units is impaired, we will record a significant non-cash impairment charge that would likely have a material adverse effect on our earnings for the period in which the impairment of goodwill occurred.



**Table of Contents****SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****Item 2: Unregistered Sales of Equity Securities and Use of Proceeds****Issuer Purchases of Equity Securities**

The following table sets forth information about the shares of Class A Common Stock we repurchased during the quarter ended June 30, 2006.

	Total Number of Shares Purchased (1)	Average Price Paid per Share (Amounts in thousands, except per share amounts)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (2)	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs
<b>April 2006</b>	<b>143,600</b>	<b>\$ 26.92</b>	<b>143,600</b>	<b>\$ 21,884</b>
<b>May 2006</b>	<b>108,000</b>	<b>\$ 25.84</b>	<b>108,000</b>	<b>\$ 19,094</b>
<b>June 2006</b>	<b>165,000</b>	<b>\$ 23.50</b>	<b>165,000</b>	<b>\$ 15,216</b>
<b>Total</b>	<b>416,600</b>	<b>\$ 25.29</b>	<b>416,600</b>	

- (1) All shares repurchased were part of publicly announced share repurchase programs  
(2) Our publicly announced Class A Common Stock repurchase authorizations occurred as follows:

	(Amounts in thousands)
November 1999	\$ 25,000
February 2000	25,000
December 2000	25,000
May 2001	25,000
August 2002	25,000
February 2003	20,000
December 2003	20,000
July 2004	20,000
<b>Total</b>	<b>\$ 185,000</b>

See Note 6 to our annual consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2005 for a description of restrictions on the payment of dividends.

**Table of Contents****SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES****Item 4: Submission of Matters to a Vote of Security Holders**

At the annual meeting of stockholders held April 20, 2006 Mr. O. Bruton Smith, Mr. Jeffrey C. Rachor, and Mr. William R. Brooks were voted on by Sonic's stockholders. Directors whose terms of office continued after the meeting were B. Scott Smith, William P. Benton, H. Robert Heller, Robert L. Rewey, and William I. Belk. Mr. Thomas P. Capo did not stand for re-election as a director of Sonic.

	Votes For	Votes Withheld
Election of O. Bruton Smith	144,500,206	789,498
Election of Jeffrey C. Rachor	144,466,227	823,477
Election of William R. Brooks	144,379,379	910,325

In addition to the election of the three directors, the stockholders approved the appointment of Deloitte & Touche as Sonic's independent registered public accounting firm for the fiscal year ending December 31, 2006.

	Votes For	Votes Against	Votes Abstained	Broker Non-Votes
Ratification of Deloitte & Touche as the independent registered public accounting firm	144,845,809	443,794	100	

**Item 6: Exhibits.****(a) Exhibits:**

Exhibit No.	Description
31.1	Certification of Mr. David P. Cospers pursuant to rule 13a-14 (a).
31.2	Certification of Mr. O. Bruton Smith pursuant to Rule 13a-14 (a).
32.1	Certification of Mr. David P. Cospers pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Mr. O. Bruton Smith pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

**Forward Looking Statements**

This Quarterly Report on Form 10-Q contains numerous forward-looking statements within the meaning of the Private Litigation Securities Reform Act of 1995. These forward-looking statements address our future objectives, plans and goals, as well as our intent, beliefs and current expectations regarding future operating performance, and can generally be identified by words such as may, will, should, believe, expect, anticipate, intend, plan, foresee and other similar words or phrases. Specific events addressed by these forward-looking statements include, but are not limited to:

future acquisitions or dispositions;

industry trends;

general economic trends, including employment rates and consumer confidence levels;

vehicle sales rates and same store sales growth;

our financing plans; and

our business and growth strategies.

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

our ability to generate sufficient cash flows or obtain additional financing to support acquisitions, capital expenditures, our share repurchase program, dividends on our Common Stock and general operating activities;

the reputation and financial condition of vehicle manufacturers whose brands we represent, the financial incentives they offer and their ability to design, manufacture, deliver and market their vehicles successfully;

our relationships with manufacturers, which may affect our ability to complete additional acquisitions;

changes in laws and regulations governing the operation of automobile franchises, accounting standards, taxation requirements, and environmental laws;

general economic conditions in the markets in which we operate, including fluctuations in interest rates, employment levels, the level of consumer spending and consumer credit availability;

high competition in the automotive retailing industry, which not only creates pricing pressures on the products and services we offer, but on businesses we seek to acquire; and

the timing of and our ability to successfully integrate recent and potential future acquisitions.

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

**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.

**SONIC AUTOMOTIVE, INC.**

Date: August 3, 2006

By: /s/ O. Bruton Smith  
O. Bruton Smith  
*Chairman and Chief Executive Officer*

Date: August 3, 2006

By: /s/ David P. Cospers  
David P. Cospers  
*Executive Vice President, Chief Financial Officer, and Treasurer  
(Principal Financial Officer)*

**Table of Contents**

**SONIC AUTOMOTIVE, INC. AND SUBSIDIARIES**

**EXHIBIT INDEX**

<b>Exhibit No.</b>	<b>Description</b>
31.1	Certification of Mr. David P. Cospers pursuant to rule 13a - 14 (a).
31.2	Certification of Mr. O. Bruton Smith pursuant to Rule 13a - 14 (a).
32.1	Certification of Mr. David P. Cospers pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Mr. O. Bruton Smith pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.