

GLEACHER & COMPANY, INC.

Form 10-Q

May 10, 2013

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

Washington, D.C. 20549

**FORM 10-Q**

**x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**for the quarterly period ended March 31, 2013**

**- or -**

**o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**for the transition period from            to**

**Commission file number 014140**

**GLEACHER & COMPANY, INC.**

(Exact name of registrant as specified in its charter)

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**Delaware**

(State or other jurisdiction of incorporation or organization)

**22-2655804**

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

**1290 Avenue of the Americas, New York, New York**

(Address of principal executive offices)

**10104**

(Zip Code)

Registrant's telephone number, including area code **(212) 273-7100**

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

Yes ☒ x

No ☐ o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes ☒ x

No ☐ o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer ☐ o

Accelerated Filer ☒ x

Non-accelerated Filer ☐ o (Do not check if a smaller reporting company)

Smaller Reporting Company ☐ o

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

Yes ☐ o

No ☒ x

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

122,980,847 shares of Common Stock were outstanding as of the close of business on April 30, 2013



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**GLEACHER & COMPANY, INC. AND SUBSIDIARIES**

FORM 10-Q

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GLEACHER & COMPANY, INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(Unaudited)

**Part I Financial Information****Item 1. Financial Statements**

(In thousands, except for per share amounts)		Three Months Ended March 31,	
		2013	2012
<i>Revenues:</i>			
Principal transactions	\$	(6,999)	\$ 8,499
Commissions		10,181	19,151
Investment banking		15,173	6,678
Investment gains/(losses), net		172	132
Interest income		8,966	16,761
Fees and other		964	514
Total revenues		28,457	51,735
Interest expense		1,607	2,769
Net revenues		26,850	48,966
<i>Expenses (excluding interest):</i>			
Compensation and benefits		29,115	39,392
Professional fees		3,227	3,556
Communications and data processing		3,147	3,252
Occupancy, depreciation and amortization		1,908	1,916
Clearing, settlement and brokerage		1,009	1,570
Business development		753	918
Other		1,269	720
Total expenses (excluding interest)		40,428	51,324
Loss from continuing operations before income taxes and discontinued operations		(13,578)	(2,358)
Income tax expense		85	674
Loss from continuing operations		(13,663)	(3,032)
Loss from discontinued operations, net of taxes (Refer to Note 24)		(4,308)	(1,652)
Net loss	\$	(17,971)	\$ (4,684)
Per share data:			
Basic loss per share			
Continuing operations	\$	(0.11)	\$ (0.03)
Discontinued operations		(0.04)	(0.01)
Net loss per share	\$	(0.15)	\$ (0.04)
Diluted loss per share			
Continuing operations	\$	(0.11)	\$ (0.03)
Discontinued operations		(0.04)	(0.01)
Net loss per share	\$	(0.15)	\$ (0.04)
Weighted average shares of common stock:			

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Basic	119,510	119,510
Diluted	119,510	119,510

The accompanying notes are an integral part  
of these consolidated financial statements.

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GLEACHER & COMPANY, INC.

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(Unaudited)

(In thousands of dollars, except for share and per share amounts)	March 31, 2013	December 31, 2012
<i>Assets</i>		
Cash and cash equivalents	\$ 40,412	\$ 44,868
Cash and securities segregated for regulatory and other purposes	6,000	13,000
Securities purchased under agreements to resell	20,816	
Receivables from:		
Brokers, dealers and clearing organizations	13,437	12,824
Related parties	1,474	1,474
Others	10,078	12,563
Financial instruments owned, at fair value (includes financial instruments pledged of \$478,427 and \$1,095,431 at March 31, 2013 and December 31, 2012, respectively)	479,232	1,096,181
Loans held for sale, ClearPoint, at fair value	7,693	
Investments	21,597	20,478
Office equipment and leasehold improvements, net	4,507	5,311
Goodwill	1,212	1,212
Intangible assets	4,551	5,303
Income taxes receivable	4,379	7,394
Deferred tax assets, net		
Other assets	10,008	9,030
Total Assets	\$ 625,396	\$ 1,229,638
<i>Liabilities and Stockholders' Equity</i>		
<i>Liabilities</i>		
Payables to:		
Brokers, dealers and clearing organizations	\$ 409,213	\$ 638,009
Related parties	2,984	2,944
Others	2,684	2,251
Securities sold under agreements to repurchase		159,386
Securities sold, but not yet purchased, at fair value	21,713	132,730
Secured borrowings, ClearPoint	4,272	64,908
Accrued compensation	9,568	34,199
Accounts payable and accrued expenses	7,519	9,866
Income taxes payable	3,827	3,755
Subordinated debt	595	595
Total Liabilities	462,375	1,048,643
<i>Commitments and Contingencies (Refer to Note 16)</i>		
<i>Stockholders' Equity</i>		
Common stock; \$.01 par value; authorized 200,000,000 shares, issued 133,769,219 and 133,769,219 shares; and outstanding 122,942,752 and 124,440,655 shares, at March 31, 2013 and December 31, 2012, respectively	1,337	1,337
Additional paid-in capital	454,779	453,938
Deferred compensation	124	124
Accumulated deficit	(281,548)	(263,577)
	(11,671)	(10,827)

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Treasury stock, at cost (10,826,427 shares and 9,328,564 shares, at March 31, 2013 and December 31, 2012, respectively)

Total Stockholders	Equity			163,021		180,995
Total Liabilities and Stockholders	Equity		\$	625,396	\$	1,229,638

The accompanying notes are an integral part  
of these consolidated financial statements.



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## GLEACHER &amp; COMPANY, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands of dollars)	Three Months Ended March 31,	
	2013	2012
<i>Cash flows from operating activities:</i>		
Net loss	\$ (17,971)	\$ (4,684)
<i>Adjustments to reconcile net loss to net cash provided by operating activities:</i>		
Amortization of stock-based compensation	1,107	4,497
Impairment of intangible assets ClearPoint	587	
Depreciation of fixed assets and amortization of leasehold improvements	439	487
Clawback of stock-based compensation awards subject to non-competition provisions	(361)	
Investment losses/(gains), net	(172)	(132)
Amortization of intangible assets	165	124
Deferred income taxes		3,697
<i>Changes in operating assets and liabilities:</i>		
Cash and securities segregated for regulatory and other purposes	7,000	7,612
Securities purchased under agreements to resell	(20,816)	(1,461,657)
Net receivable from others	2,918	1,327
Financial instruments owned, at fair value	617,894	97,387
Loans held for sale, ClearPoint, at fair value	(7,693)	
Income taxes receivable/payable, net	3,087	2,725
Other assets	(1,003)	
Net payable to brokers, dealers and clearing organizations	(229,409)	(85,694)
Securities sold under agreements to repurchase	(159,386)	1,501,525
Securities sold, but not yet purchased, at fair value	(111,017)	48,503
Accounts payable and accrued expenses	(3,282)	(4,964)
Accrued compensation	(24,631)	(15,835)
Drafts payable	935	269
Net cash provided by operating activities	58,391	95,187
<i>Cash flows from investing activities:</i>		
Purchase of investments	(947)	
ClearPoint sale - net payment to Homeward Residential, Inc. (Refer to Note 1)	(510)	
Purchases of office equipment and leasehold improvements	(7)	(360)
Net cash used in investing activities	(1,464)	(360)
<i>Cash flows from financing activities:</i>		
Proceeds from secured borrowings	185,381	583,000
Repayments of secured borrowings	(246,017)	(679,416)
Payment for employee tax withholdings on stock-based compensation	(747)	(2,403)
Excess tax benefits related to stock-based compensation		8
Net cash used in financing activities	(61,383)	(98,811)
Decrease in cash and cash equivalents	(4,456)	(3,984)
Cash and cash equivalents at beginning of the period	44,868	36,672
Cash and cash equivalents at the end of the period	\$ 40,412	\$ 32,688

## NON CASH INVESTING AND FINANCING ACTIVITIES

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During the three months ended March 31, 2013 and 2012, the Company issued approximately 0.0 million and 6.9 million shares out of treasury stock, net of forfeitures, respectively, for stock-based compensation exercises and vesting.

The accompanying notes are an integral part  
of these consolidated financial statements.

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GLEACHER & COMPANY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

***1. Basis of Presentation***

Organization and Nature of Business

Gleacher & Company, Inc. (the "Parent" and together with its subsidiaries, the "Company") is an independent investment bank that provides clients with strategic and financial advisory services, including merger and acquisition, restructuring, recapitalization, and strategic alternative analysis. The Company is incorporated under the laws of the State of Delaware. The Company's common stock is traded on The NASDAQ Global Market ("NASDAQ") under the symbol "GLCH".

The Company also provided residential mortgage lending services through its subsidiary ClearPoint Funding Inc. ("ClearPoint"). On February 14, 2013, the Company entered into an agreement to sell substantially all of ClearPoint's assets to Homeward Residential, Inc. ("Homeward Transaction"). The Homeward transaction closed on February 22, 2013, and all remaining business activities of ClearPoint have been substantially wound down. ClearPoint's results have been reclassified as discontinued operations. Refer to Notes 23 and 24 herein for additional information.

Recent Developments

On April 5, 2013, the Company's Board of Directors approved a plan to discontinue operations in its MBS & Rates and Credit Products divisions. The plan is expected to be completed by the end of the second quarter 2013. The results of these divisions will also be reclassified as discontinued operations in the second quarter 2013. Refer to Note 27 herein for additional information.

The Company's ability to generate revenue and continue business operations subsequent to exiting its MBS & Rates and Credit Products businesses depends principally on its Investment Banking activity, and in particular, generating fees for financial advisory services. Given the Company's state, its ability to generate Investment Banking revenues is currently uncertain. Unless the Company is able to generate significant Investment Banking revenues, or develop new and profitable business lines, the Company will continue to operate at a loss.

At the Company's 2013 Annual Stockholders Meeting to be held May 23, the board of directors will be largely reconstituted. The composition of the board at that time cannot be predicted with certainty, and consequently the Company's strategic direction and operational initiatives are not known at this time. Accordingly, the Company's financial position at future dates and its results of operations for periods subsequent to the 2013 Annual Stockholders Meeting are highly uncertain.

Policies and Presentation

The accounting and financial reporting policies of the Company conform to accounting principles generally accepted in the United States of America ( GAAP ). The consolidated financial statements prepared in conformity with GAAP requires management to make estimates and assumptions that affect reported amounts of assets, liabilities, revenues and expenses, and the disclosure of contingent assets and liabilities. Actual results could be different from these estimates. In the opinion of management, all normal, recurring adjustments necessary for a fair statement of this interim financial information are contained in the accompanying consolidated financial statements. The results for any interim period are not necessarily indicative of those for the full year.

The accompanying consolidated financial statements are presented in accordance with the U.S. Securities and Exchange Commission ( SEC ) requirements for Quarterly Reports on Form 10-Q and are unaudited. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been omitted. Reference should be made to the Company 's audited consolidated financial statements and notes within the Company 's Annual Report on Form 10-K for the year ended December 31, 2012 for additional information, including a summary of the Company 's significant accounting policies.

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GLEACHER & COMPANY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Correction of an Error and Certain Reclassifications

During the preparation of the Company's Quarterly Report on Form 10-Q for the three months ended March 31, 2013, the Company determined that it had incorrectly reserved for approximately \$1.9 million of principal receivable on a particular position within the Company's financial instruments owned during the prior three years ended December 31, 2012, primarily during the year ended December 31, 2011. The Company assessed this error and determined that it was not material to the previous reporting periods and is not material to the current year. Therefore, the Company has recorded this item as an out of period adjustment to principal transactions within the Consolidated Statements of Operations for the three months ended March 31, 2013.

In addition, certain amounts in prior periods have been reclassified to conform to the current year presentation with no impact to previously reported net loss or stockholders' equity. This includes the prior period results of ClearPoint, which are now being reported as discontinued operations. Refer to Note 24 herein for additional information.

Recent Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2013-02 Other Comprehensive Income Reporting Amounts Reclassified Out of Accumulated Other Comprehensive Income (ASU 2013-02). The objective of ASU 2013-02 is to improve the reporting of reclassifications out of accumulated other comprehensive income. This ASU seeks to attain that objective by requiring an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under GAAP to be reclassified in its entirety to net income. For other amounts that are not required under GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under GAAP that provide additional detail about those amounts. This guidance is effective prospectively for reporting periods beginning after December 15, 2012. ASU 2013-02 is not applicable to the Company as it has no items reported as other comprehensive income.

In January 2013, the FASB issued ASU No. 2013-01 Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities (ASU 2013-01). The main objective of ASU 2013-01 is to address implementation issues about the scope of ASU No. 2011-11 Disclosures about Offsetting Assets and Liabilities (ASU 2011-11), which requires new disclosures about balance sheet offsetting and related arrangements. For derivative financial assets and liabilities, the amendments require disclosure of gross asset and liability amounts, amounts offset on the balance sheet, and amounts subject to offsetting requirements but not offset in the balance sheet. ASU 2013-01 clarifies that the scope of ASU 2011-11 applies to derivatives, including embedded bifurcated derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are offset in accordance with applicable accounting literature or subject to an enforceable master netting arrangement or similar agreement. This guidance is effective for annual reporting periods beginning on or after January 1, 2013 and is to be applied retrospectively. This guidance does not amend the existing guidance on when it is appropriate to offset, and since these amended principles require only additional disclosures, the adoption of ASU 2011-11 did not affect the Company's financial condition, results of

operations or cash flows.

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## GLEACHER &amp; COMPANY, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**2. (Loss)/Earnings Per Common Share**

The Company calculates basic and diluted (loss)/earnings per share in accordance with ASC 260, Earnings Per Share. Basic (loss)/earnings per share is computed based upon weighted-average shares outstanding during the period. Dilutive (loss)/earnings per share is computed consistently with the basic computation while giving effect to all dilutive potential common shares and common share equivalents that were outstanding during the period. The Company uses the treasury stock method to reflect the potential dilutive effect of unvested stock awards, warrants, and unexercised options. The weighted-average shares outstanding were calculated as follows:

(In thousands of shares)	Three Months Ended March 31,	
	2013	2012
Weighted average shares for basic (loss)/earnings per share	119,510	119,510
Effect of dilutive common share equivalents		
Weighted average shares and dilutive common share equivalents for dilutive (loss)/earnings per share	119,510	119,510

For the three months ended March 31, 2013 and March 31, 2012, the Company was in a net loss position and therefore excluded approximately 9.1 million and 10.1 million, respectively, of shares underlying stock options, 3.5 million and 9.2 million, respectively, of shares of restricted stock, and 4.1 million and 4.9 million, respectively, of shares underlying restricted stock units ( RSUs ) from its computation of dilutive loss per share because they were anti-dilutive.

**3. Cash and Cash Equivalents**

The Company has defined cash equivalents as highly liquid investments, with original maturities of less than 90 days that are not segregated for regulatory purposes or held for sale in the ordinary course of business. At March 31, 2013 and December 31, 2012, cash equivalents were approximately \$3.2 million and \$3.1 million, respectively. Cash and cash equivalents of approximately \$27.1 million and \$21.8 million at March 31, 2013 and December 31, 2012, respectively, were held at one financial institution.

**4. Cash and Securities Segregated for Regulatory and Other Purposes**

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The Company self-clears its trading activities in U.S. government securities (the Rates business ) and is therefore subject to the Customer Protection rules under Rule 15c3-3 promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act ). These activities will be discontinued in the second quarter of 2013. At March 31, 2013 and December 31, 2012, the Company segregated cash of \$1.0 million and \$1.0 million, respectively, in a special reserve bank account for the exclusive benefit of customers pertaining to the activities of the Company's Rates business and items related to when the Company was previously conducting self-clearing in prior years, including outstanding checks issued to customers and vendors, and other miscellaneous items.

In addition, cash and securities segregated for regulatory and other purposes at March 31, 2013 include \$5.0 million, representing cash deposited into an escrow account by ClearPoint in connection with the Homeward Transaction. Refer to Note 16 herein for additional information. Cash segregated at December 31, 2012 includes \$12.0 million of cash on deposit with ClearPoint's warehouse lenders in connection with ClearPoint's loan origination activities, now discontinued.



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## GLEACHER &amp; COMPANY, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**5. Resale and Repurchase Agreements**

Refer to Note 1 within the footnotes to the consolidated financial statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 for a detailed discussion of accounting policies related to the Company's resale and repurchase agreements.

At March 31, 2013 and December 31, 2012, the fair value of financial instruments held as collateral by the Company that it was permitted to deliver or repledge in connection with resale agreements was approximately \$20.8 million and \$137.9 million, respectively, substantially all of which was repledged to cover securities sold, but not yet purchased at March 31, 2013 and in the form of repurchase agreements at December 31, 2012.

The following table below presents the gross and net information about the Company's resale and repurchase agreements that are offset in the financial statements:

(in thousands of dollars)		March 31, 2013			December 31, 2012		
Asset / Liability	Collateral Type	Gross Amounts	Netting	Net Amounts	Gross Amounts	Netting	Net Amounts
Resale agreements	U.S. government and federal agency obligations	\$ 20,816	\$	\$ 20,816	\$ 238,014	\$ (238,014)	\$
Repurchase agreements	U.S. government and federal agency obligations	\$	\$	\$	\$ 397,400	\$ (238,014)	\$ 159,386

The following tables provide detail on the maturity composition of the outstanding repurchase agreements at December 31, 2012 (there were no outstanding repurchase agreements at March 31, 2013):

(In thousands of dollars)		December 31, 2012				On Demand	Total, net
Collateral Type		Overnight	< 30 days	30-90 days	> 90 days		
U.S. government and federal agency obligations		\$ 106,991	\$ 50,052	\$	\$	\$ 2,343	\$ 159,386



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GLEACHER & COMPANY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**6. Receivables from and Payables to Brokers, Dealers, and Clearing Organizations**

Amounts receivable from and payable to brokers, dealers and clearing organizations consists of the following:

<b>(In thousands of dollars)</b>	<b>March 31, 2013</b>	<b>December 31, 2012</b>
Deposits with clearing organizations	\$ 8,266	\$ 9,566
Receivable from clearing organizations	3,715	2,001
Receivable for unsettled trading activities	1,094	237
Underwriting and syndicate fees receivable	362	1,020
<b>Total receivables</b>	<b>\$ 13,437</b>	<b>\$ 12,824</b>
Payable to clearing organizations	408,666	638,009
Payable for unsettled trading activities	547	
<b>Total payables</b>	<b>\$ 409,213</b>	<b>\$ 638,009</b>

Included within deposits with clearing organizations at March 31, 2013 and December 31, 2012 is a deposit with the Fixed Income Clearing Corporation ( FICC ) of approximately \$6.3 million and \$8.8 million, respectively, related to the Company's self clearing activities associated with the Rates business.

Payable to clearing organizations at March 31, 2013 and December 31, 2012 included approximately \$37.6 million and \$35.5 million, respectively, of excess equity (funds that are readily available to the Company) held at the Company's principal clearing broker.

Securities transactions are recorded on their trade date as if they had settled. The related amounts receivable and payable for unsettled securities transactions are recorded net, by clearing organization, in Receivables from or Payables to brokers, dealers and clearing organizations in the Consolidated Statements of Financial Condition. The clearing organization may re-hypothecate all securities held on behalf of the Company.

**7. Receivables from and Payables to Others**

Amounts Receivable from and Payable to Others consist of the following:

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(In thousands of dollars)		March 31, 2013		December 31, 2012	
Principal paydowns	Agency mortgage-backed securities	\$	5,354	\$	5,744
Interest receivable			2,211		4,370
Loans and advances			294		234
Management fees receivable			198		189
Investment banking and advisory fees receivable			155		144
Others			1,866		1,882
Total receivables from others		\$	10,078	\$	12,563
Payable to employees for the Employee Investment Funds (Refer to Note 10)		\$	971	\$	941
Draft payables			1,068		133
Others			645		1,177
Total payables to others		\$	2,684	\$	2,251

The Company maintains a group of zero balance bank accounts which are included in Payable to others on the Consolidated Statements of Financial Condition. Drafts payable represent the balance in these accounts related to outstanding checks that have not yet been presented for payment at the bank. The Company has sufficient funds on deposit to clear these checks, and these funds will be transferred to the zero-balance accounts upon presentment.

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GLEACHER & COMPANY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**8. Financial Instruments**

Refer to Note 1 within the footnotes to the consolidated financial statements contained within Item 8 of the Company's Annual Report on Form 10-K for the year ended December 31, 2012 for a detailed discussion of accounting policies related to the Company's financial instruments & investments, loans and derivative financial instruments.

The Company's financial instruments, which are held primarily in connection with the business activities of the Company's MBS & Rates division (which are being discontinued in the second quarter of 2013), are recorded within the Consolidated Statements of Financial Condition at fair value. ASC 820 Fair Value Measurements and Disclosures defines fair value as the price that would be received upon the sale of an asset or paid upon the transfer of a liability (i.e., the exit price) in an orderly transaction between market participants at the measurement date and establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company's assumptions about the assumptions market participants would use in pricing the asset or liability based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the reliability of inputs as follows:

Level 1: Quoted prices in active markets that the Company has the ability to access at the reporting date, for identical assets or liabilities.

Level 2: Directly or indirectly observable prices in active markets for similar assets or liabilities; quoted prices for identical or similar items in markets that are not active; inputs other than quoted prices (e.g., interest rates, yield curves, credit risks, volatilities); or market corroborated inputs.

Level 3: Unobservable inputs that reflect management's own assumptions about the assumptions market participants would make.

\*\* Prices are not adjusted for the effects, if any, of the Company holding a large block relative to the overall trading volume (referred to as a blockage factor).

The availability of observable inputs can vary from product to product and is affected by a wide variety of factors, including, for example, the type of product, whether the product is new and not yet established in the marketplace, and other characteristics particular to the transaction. To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value

requires more judgment. Accordingly, the degree of judgment exercised by management in determining fair value is greatest for instruments categorized in Level 3. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, for disclosure purposes, the level in the fair value hierarchy within which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety.

ASC 820 also provides (i) general guidance on determining fair value when markets are inactive including the use of judgment in determining whether a transaction in a dislocated market represents fair value, the inclusion of market participant risk adjustments when an entity significantly adjusts observable market data based on unobservable inputs, and the degree of reliance to be placed on broker quotes or pricing services as well as (ii) additional guidance for estimating fair value when the volume and level of activity for the asset or liability have significantly declined and guidance on identifying circumstances that indicate a transaction is not orderly.

#### Fair Valuation Methodology

**Cash Equivalents** These financial assets represent cash in banks or cash invested in highly liquid investments with original maturities less than 90 days that are not segregated for regulatory purposes or held for sale in the ordinary course of business. These investments are valued at par, which represent fair value, and are considered Level 1. Refer to Note 3 herein for additional information.

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GLEACHER & COMPANY, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**Financial Instruments Owned/Securities Sold But Not Yet Purchased, at Fair Value** These financial instruments primarily consist of investments in fixed income securities, as well as holdings in equity securities. The Company has no direct exposure to European sovereign debt.

*Level 1 Cash Instruments*

Level 1 cash instruments generally include U.S. government obligations and actively traded listed preferred stock and equity securities (if not subject to legal restriction on transfer). These instruments are traded in active, quoted and highly liquid markets.

*Level 2 Cash Instruments*

Level 2 cash instruments generally include agency mortgage-backed securities, federal agency obligations, corporate debt, certain preferred stock, asset-backed and non-agency residential and commercial mortgage-backed securities and certain other debt obligations. In addition, Level 2 cash instruments also include mortgage loans originated by ClearPoint for which the fair value option ( FVO ) has been elected.

In determining fair value for Level 2 financial instruments, management considers recent purchases or sales of the financial assets, benchmark securities and yields, discounted cash flow techniques, recently executed market transactions of comparable size, issuer spreads and bids/offers. Fair value for ClearPoint's loans is determined primarily based upon the prospective investor buy price.

*Level 3 Cash Instruments*

Level 3 cash instruments generally include non-agency commercial and residential mortgage backed securities positions, collateralized debt obligations, certain agency mortgage-backed securities and certain other debt obligations. In determining fair value for Level 3 financial instruments, management maximizes the use of market observable information when available. Management considers factors such as recent purchases of the financial assets, discounted cash flow techniques, bids that were received, and various benchmarking techniques, including spread comparisons to other similar financial assets recently traded, or spreads to observable factors such as yield curves. Management considers its valuation methodologies consistent with how other market participants value similar financial assets.

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Level 3 cash instruments also includes the Company's investment in FA Technology Ventures, L.P. ( "FATV" or "the Partnership" ), further described below.

**Derivatives** These financial instruments primarily consist of TBAs, exchange traded futures and options contracts. In addition, the prior-year period included ClearPoint forward sales and interest rate lock commitments ( "IRLCs" ).

**TBAs:** The Company utilizes derivatives for trading strategies and economic hedging strategies. The Company economically hedges certain of its mortgage-backed and U.S. government securities trading. The Company also economically hedged the mortgage lending activities of ClearPoint (the activities of which have been discontinued in connection with the Homeward Transaction), through the use of TBAs and forward sale agreements. A TBA is a forward mortgage-backed security whose collateral remains "to-be-announced" until just prior to the trade settlement.

**Exchange traded futures and options contracts:** The Company utilized these financial instruments primarily for hedging strategies. These contracts are traded in active quoted markets and therefore are also generally classified as Level 1.

**IRLCs:** ClearPoint had entered into mortgage loan IRLCs in connection with its mortgage lending activities. These activities have been wound down in connection with the Homeward Transaction. At December 31, 2012, the fair value of the IRLCs were determined on an individual loan basis and are based on investor pricing tables stratified by product, note rate and term and considered the servicing release premium, expected loan origination fees and costs and loan pricing adjustments specific to each loan. The Company also applied an estimated rate of



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GLEACHER & COMPANY, INC.

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closure based on historical experience in determining the notional amount of the loans expected to be funded. All of these factors combined results in the classification of the IRLCs as Level 3 at December 31, 2012.

**Investments** These financial assets primarily represent the Company's investment in FATV, a venture capital limited partnership which provides early stage growth capital to companies in the information and new energy technology sectors. Valuation techniques applied by FATV GP LLC (the General Partner) to the underlying portfolio companies predominantly include consideration of comparable market transactions and the use of valuation models to determine the discounted value of estimated future cash flows, adjusted as appropriate for market and/or other risk factors. Historically, FATV held equity securities in public companies which were valued based upon quoted market prices. This investment is classified as Level 3 as the majority of the valuation techniques involve some level of management estimation and judgment, the degree of which is dependent on the price transparency for the instruments or market and the instruments' complexity.

Valuation Processes and Controls

At March 31, 2013, the Company's sales and trading professionals in its MBS & Rates and Credit Products divisions (which will be discontinued in the second quarter of 2013) were responsible for pricing its financial instruments. The Company employs an independent control process in order to validate these prices. This control process, which involves both the Company's risk management and finance personnel, is designed to ensure that the values used for financial reporting are based on observable inputs wherever possible. In the event that observable inputs are not available, the control processes are designed to assure that the valuation approach utilized is appropriate and consistently applied and that the assumptions are reasonable.

Fair value is generally determined through a variety of factors, such as recent purchases or sales of the financial assets, bids that were received, and various benchmarking techniques, including spread comparisons to other similar assets recently traded or spreads to other observable factors such as yield curves. The Company's independent control process includes leveraging pricing information obtained from external data providers to assess the reasonableness of its marks, generally for the Company's most highly liquid financial instruments, as this data tends to be generally reliable for positions that are actively traded. For the Company's less liquid financial instruments, the Company's independent control process includes comparing month-end marks to recent trading activity, benchmarking price changes to observable market indices, reviewing benchmarking techniques and analyzing external pricing data for trends. These independent procedures are critical to ensuring the Company's financial instruments are properly valued.

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## GLEACHER &amp; COMPANY, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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Fair Value Hierarchy

The following table summarizes the categorization of the financial instruments within the fair value hierarchy at March 31, 2013:

(In thousands of dollars)	Assets at Fair Value				Total
	Level 1	Level 2	Level 3		
Financial instruments owned					
Agency mortgage-backed securities	\$	\$ 462,940	\$ 5	\$	462,945
Federal agency obligations		12,144			12,144
Corporate debt securities		1,156			1,156
Residential mortgage-backed securities		438	91		529
Equity securities	730		28		758
U.S. government obligations	25				25
Commercial mortgage-backed securities			18		18
Collateralized debt obligations		998	659		1,657
Total financial instruments owned, at fair value	755	477,676	801		479,232
Loans held for sale, ClearPoint, at fair value		7,693			7,693
Investments			21,597		21,597
Total	\$ 755	\$ 485,369	\$ 22,398	\$	508,522

(In thousands of dollars)	Liabilities at Fair Value				Total
	Level 1	Level 2	Level 3		
Securities sold, but not yet purchased					
U.S. government obligations	\$ 20,034	\$	\$	\$	20,034
Corporate debt securities		39			39
Derivatives (1)	1,640				1,640
Total securities sold, but not yet purchased	\$ 21,674	\$ 39	\$	\$	21,713

(1) Unrealized gains/(losses) relating to derivatives are reported in Financial instruments owned and Securities sold, but not yet purchased, at fair value in the Consolidated Statements of Financial Condition.

Included below is a discussion of the characteristics of certain of the Company's Level 2 and Level 3 holdings at March 31, 2013. Unless otherwise stated, fair value of Level 2 assets are determined based upon observable third party information including recent trading activity, broker quotes and other relevant market data as noted above. Fair values for Level 3 assets are based predominantly on management's own assumptions about the assumptions market participants would make.

*Financial Instruments Classified as Level 2*

The Company's agency mortgage-backed securities positions classified as Level 2, of approximately \$462.9 million, have a weighted average loan size of approximately \$0.1 million paying interest of 4.4%, with a weighted average FICO score of 712. This portfolio has a weighted average coupon remitting payment of 3.5% and has a weighted average annualized constant prepayment rate of approximately 8.2%. Fair value is determined through a combination of matrix pricing as well as the information noted in the preceding paragraph.

The Company's Level 2 federal agency obligations of approximately \$12.1 million have a weighted average coupon of 2.2% and a weighted average maturity of 2022.

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(Unaudited)

The Company's Level 2 loans of approximately \$7.7 million (unpaid principal of approximately \$7.7 million), which are related to the mortgage lending activities of ClearPoint and for which the FVO has been elected, have a weighted average loan size of approximately \$0.2 million and has a weighted average coupon remitting payment of 3.7%. There are no unrealized gains or losses arising from fair value changes of these loans as of March 31, 2013 and there are no loans 90 days or more past due and no loans are in non-accrual status. The loans are underwritten using standards prescribed by conventional mortgage lenders and loan buyers such as the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation.

The Company's net holdings of corporate debt securities classified as Level 2 of approximately \$1.1 million have a weighted average credit rating of BB, have a weighted average issuance year of 2010 and a weighted average maturity of 2030.

*Financial Instruments Classified as Level 3*

**Investments Quantitative Disclosure About Significant Unobservable Inputs**

The Company's investments of approximately \$21.6 million classified as Level 3, includes the Company's investment in FATV of approximately \$17.3 million, which is comprised of 19 holdings primarily in 7 privately held companies. Refer to Note 10 herein for additional information.

Valuation Technique	Unobservable Input	Range (Weighted Average)
Market comparable companies	Enterprise value/Revenue multiple	1.5x - 6.7x (5.9x)
	Discount applied to multiples	0.0% - 40.0% (27.0%)

An increase in the enterprise value/revenue multiple would result in a higher fair value for these investments, whereas, an increase in the discounts applied to these multiples would reduce fair value.

**Nonrecurring Fair Value Measurements Quantitative Disclosure About Significant Unobservable Inputs**

The Company's assets measured at fair value on a nonrecurring basis solely relate to Goodwill arising from various business combinations which would be classified as Level 3 within the fair value hierarchy. Refer to Note 12 herein for additional information.



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## GLEACHER &amp; COMPANY, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The following table summarizes the categorization of the financial instruments within the fair value hierarchy including those for which the Company accounts for under the FVO at December 31, 2012:

(In thousands of dollars)	Assets at Fair Value				Total
	Level 1	Level 2	Level 3		
Financial instruments owned					
Agency mortgage-backed securities	\$	\$ 903,928	\$ 1,110	\$	\$ 905,038
Loans		77,573			77,573
Federal agency obligations		46,021			46,021
Corporate debt securities		30,246			30,246
Residential mortgage-backed securities		23,077	149		23,226
Commercial mortgage-backed securities		4,880	18		4,898
Preferred stock	2,439				2,439
U.S. government obligations	1,996	100			2,096
Other debt obligations		2,074			2,074
Equity securities	675		28		703
Collateralized debt obligations			671		671
Derivatives	232		964		1,196
Total financial instruments owned, at fair value	5,342	1,087,899	2,940		1,096,181
Investments			20,478		20,478
Total	\$ 5,342	\$ 1,087,899	\$ 23,418	\$	\$ 1,116,659

(In thousands of dollars)	Liabilities at Fair Value				Total
	Level 1	Level 2	Level 3		
Securities sold, but not yet purchased					
U.S. Government obligations	\$ 128,504	\$	\$	\$	\$ 128,504
Corporate debt securities		2,520			2,520
Equity securities	2				2
Derivatives	1,704				1,704
Total financial liabilities, at fair value	\$ 130,210	\$ 2,520	\$	\$	\$ 132,730

The Company reviews its financial instrument classification on a quarterly basis. As the observability and strength of valuation attributes change, reclassifications of certain financial assets or liabilities may occur between levels. The Company's policy is to utilize an end-of-period convention for determining transfers in or out of Levels 1, 2 and 3. During the three months ended March 31, 2013 and March 31, 2012, there were no transfers between Levels 1 and 2.

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## GLEACHER &amp; COMPANY, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The following table summarizes the changes in the Company's Level 3 financial instruments for the three months ended March 31, 2013:

(In thousands of dollars)	Balance at December 31, 2012	Total gains or (losses) (realized and unrealized) (1)	Purchases	Sales	Settlements	Transfers in and/or out of Level 3	Balance at March 31, 2013	Changes in unrealized gains/(losses) on Level 3 assets still held at the reporting date (1)
Agency mortgage-backed securities	\$ 1,110	\$ (45)	\$	\$ (1,060)	\$	\$	\$ 5	\$
Collateralized debt obligations	671	(12)					659	(12)
Residential mortgage-backed securities	149	4		(50)	(12)		91	
Equities	28						28	
Commercial mortgage-backed securities	18						18	
Investments	20,478	172	947				21,597	188
Derivatives	964				(964)			
Total	\$ 23,418	\$ 119	\$ 947	\$ (1,110)	\$ (976)	\$	\$ 22,398	\$ 176

(1) Realized and unrealized gains/(losses) are reported in Principal transactions in the Consolidated Statements of Operations.

The following table summarizes the changes in the Company's Level 3 financial instruments for the three months ended March 31, 2012:

(In thousands of dollars)	Balance at December 31, 2011	Total gains or (losses) (realized and unrealized) (1)	Purchases	Sales	Settlements	Transfers in and/or out of Level 3(2)	Balance at March 31, 2012	Changes in unrealized gains/(losses) on Level 3 assets still held at the reporting date (1)
Commercial mortgage-backed securities	\$ 38,154	\$ (3,505)	\$ 14,845	\$ (20,163)	\$ (134)	\$ (1,347)	\$ 27,850	\$ (3,019)
Residential mortgage-backed securities	18,419	(548)	26,529	(16,156)	(682)	(959)	26,603	(32)

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Other debt obligations	192	3	3,254	(3,131)		318	(2)
Agency mortgage-backed securities	1,367	(68)	295	(1,232)		362	(60)
Collateralized debt obligations	647	(62)				585	(61)
Equities	112	(9)				103	(10)
Preferred stock	571	106	682	(1,359)			
Investments	18,310	132			(2)	18,440	325
Derivatives	1,696	885			(1,696)	885	885
Total	\$ 79,468	\$ (3,066)	\$ 45,605	\$ (42,041)	\$ (2,514)	\$ (2,306)	\$ 75,146
							\$ (1,974)

(1) Realized and unrealized gains/(losses) are reported in Principal transactions in the Consolidated Statements of Operations.

(2) During the three months ended March 31, 2012, the Company transferred approximately \$1.3 million of commercial mortgage backed securities and approximately \$1.0 million of residential mortgage-backed securities from Level 3 to Level 2 due to price discovery resulting from Company trading activity occurring in close proximity to March 31, 2012.



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## GLEACHER &amp; COMPANY, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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**9. Derivatives**

The Company utilizes derivatives for various economic hedging strategies to actively manage its market and liquidity exposures, principally in connection with the sales and trading activities of the Company's MBS & Rates division (which are being discontinued in the second quarter of 2013). In addition, ClearPoint entered into mortgage loan IRLCs in connection with its mortgage lending activities, which have been wound down in connection with the Homeward Transaction. The following table summarizes the Company's derivative instruments as of March 31, 2013 and December 30, 2012:

		March 31, 2013			December 31, 2012		
(In thousands of dollars)	Number of Contracts	Notional	Fair Value	Number of Contracts	Notional	Fair Value	
<i>Purchase Contracts</i>							
TBA purchase agreements		\$	\$	19	\$ 202,646	\$	54
IRLCs				512	100,079		964
Total		\$	\$	531	\$ 302,725	\$	1,018
<i>Sale Contracts</i>							
TBA sale agreements	6	\$ 349,367	\$ 1,640	27	\$ 708,076	\$	(1,511)
Eurodollar futures contracts				268	268,000		(15)
Total	6	\$ 349,367	\$ 1,640	295	\$ 976,076	\$	(1,526)

Total gains/(losses) related to continuing operations (excluding ClearPoint activities), which are recorded within Principal transactions within the Consolidated Statements of Operations, were \$1.6 million and (\$1.9) million, for the three months ended March 31, 2013 and 2012, respectively.

**10. Investments**

Refer to Note 1 within the footnotes to the consolidated financial statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 for a detailed discussion of the accounting policies related to the Company's investments included within the policy titled

Financial Instruments and Investments and Note 8 herein for additional information regarding valuation techniques and inputs related to the Company's investment in FATV. The Company's investment portfolio includes interests predominantly in privately held companies and private equity securities. Fair value information regarding these investments has been aggregated and is presented below:

(In thousands of dollars)	March 31, 2013	December 31, 2012
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Investment in FATV	\$	17,251	\$	17,110
Employee Investment Funds, net of Company's ownership interest		1,249		1,218
Other investments		3,097		2,150
Total Investments	\$	21,597	\$	20,478

Investment gains and losses are comprised of the following:

(In thousands of dollars)	Three Months Ended	
	March 31,	
	2013	2012
Investments (realized and unrealized gains/(losses))	\$ 172	\$ 132

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(Unaudited)

The Company has an investment in FATV of approximately \$17.3 million and \$17.1 million at March 31, 2013 and December 31, 2012, respectively. FATV's primary purpose is to provide investment returns consistent with the risk of investing in venture capital. FA Technology Ventures Corporation, a wholly-owned subsidiary of the Company, is the investment advisor to FATV. There are no material open commitments to fund this portfolio at March 31, 2013. At March 31, 2013 and December 31, 2012, total Partnership capital for all investors in FATV equaled \$71.5 million and \$70.9 million, respectively. The term of the Partnership was scheduled to end in July 2011, subject to extension by the vote of a majority of the limited partners, as provided in the limited partnership agreement applicable to the Partnership (the Partnership Agreement). The term of the Partnership was extended pursuant to such provision and is now scheduled to terminate on July 19, 2013. The Partnership is considered a variable interest entity. The Company is not the primary beneficiary, due to other investors' level of investment in the Partnership. Accordingly, the Company has not consolidated the Partnership in these consolidated financial statements, but has only recorded the fair value of its investment, which also represented the Company's maximum exposure to loss in the Partnership at March 31, 2013 and December 31, 2012. The Company's share of management fee income derived from the Partnership for the three months ended March 31, 2013 and 2012 was \$0.2 million and \$0.2 million, respectively.

The Employee Investment Funds (EIF) are limited liability companies established by the Company for the purpose of having select employees invest in private equity securities. The EIF is managed by Broadpoint Management Corp., a wholly-owned subsidiary of the Company, which has contracted with FATV to act as an investment advisor with respect to funds invested in parallel with the Partnership. The Company has consolidated EIF resulting in approximately \$1.2 million and \$1.2 million of Investments and a corresponding Payable to others being recorded in the Consolidated Statements of Financial Condition as of March 31, 2013 and December 31, 2012, respectively. Management fees are not material.

Other investments are investments in privately held companies.

**11. Business Combinations**

*Asset Purchase RangeMark Financial Services*

On November 7, 2012, a subsidiary of the Company acquired certain assets and assumed certain liabilities from RangeMark Financial Services, Inc. and certain of its affiliates and other parties (RangeMark). RangeMark specializes in providing quantitative research, advanced analytics and customizing solutions for its clients. The aggregate purchase consideration was \$2.5 million, payable in four installments commencing September 30, 2013 through March 31, 2015. The Company has the right to transfer ownership of software-related intellectual property assets back to RangeMark, and be released of its payment and other obligations.

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This transaction has been accounted for under the acquisition method of accounting in accordance with ASC 805, Business Combinations. Goodwill of \$1.2 million (all of which is expected to be deductible for tax purposes) is calculated as the purchase premium after adjusting for the fair value of net assets acquired and primarily represents the value attributable to the assembled workforce which is subsumed into the reported goodwill. The following condensed statement of net assets acquired reflects the value assigned to RangeMarks's net assets as of the acquisition date:

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**Condensed Statement of Net Assets Acquired**

(In thousands of dollars)	November 7, 2012
<b>Assets</b>	
Receivables	\$ 106
Intangible assets*	1,530
Other assets	40
<b>Total assets acquired</b>	<b>\$ 1,676</b>
<b>Liabilities</b>	
Accrued expenses and other liabilities	\$ 538
<b>Total liabilities assumed</b>	<b>\$ 538</b>
<b>Net assets acquired</b>	<b>\$ 1,138</b>
<b>Purchase price (present value)</b>	<b>2,350</b>
<b>Goodwill resulting from transaction</b>	<b>\$ 1,212</b>

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\*Consists primarily of intellectual property and the trade name with estimated useful lives of 5 years and 10 years, respectively.

**12. Goodwill and Intangible Assets**

Refer to Note 1 within the footnotes to the consolidated financial statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 for a detailed discussion of the accounting policy related to goodwill and intangible assets.

**Goodwill**

The Company has designated November 1st as its annual impairment testing date for the goodwill related to the acquisition of certain assets and assumption of certain liabilities of RangeMark. The Company's initial annual impairment testing date related to this goodwill is scheduled to be on November 1, 2013, absent a triggering event. The following table sets forth the roll-forward of goodwill for the three months ended March 31, 2013.

(In thousands of dollars)

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Goodwill RangeMark acquisition	
Balance at December 31, 2012	\$ 1,212
Increases/(decreases)	
Balance at March 31, 2013	\$ 1,212

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(Unaudited)

**Intangible Assets**

(In thousands of dollars)		March 31,	December 31,			
		2013	2012			
Intangible assets (amortizable):						
MBS & Rates segment						
Customer relationships						
Gross carrying amount	\$	641	\$	641		
Accumulated amortization		(476)		(463)		
Net carrying amount		165		178		
RangeMark Intellectual Property						
Gross carrying amount		1,050		1,050		
Accumulated amortization		(87)		(35)		
Net carrying amount		963		1,015		
RangeMark Trade Name						
Gross carrying amount		480		480		
Accumulated amortization		(20)		(8)		
Net carrying amount		460		472		
Credit Products segment -						
Customer relationships						
Gross carrying amount		795		795		
Accumulated amortization		(795)		(768)		
Net carrying amount				27		
Investment Banking segment Trade name						
Gross carrying amount		4,066		4,066		
Accumulated amortization		(1,103)		(1,057)		
Net carrying amount		2,963		3,009		
ClearPoint segment						
Customer relationships						
Gross carrying amount		803		803		
Accumulated amortization		(216)		(201)		
Impairment of intangible asset February 22, 2013				(587)		
Net carrying amount				602		
Total Intangible assets		1,788		3.2	\$ 17.07	1,664
\$	19.82		1,932	4.9	\$ 19.82	904
	22.28					
	to					
\$	\$24.99		1,553	3.8	\$24.97	1,166
\$	25.39		1,943	6.7	\$25.41	71
	to					

\$25.79

Total	14,610	4.7	\$16.95	9,022	\$15.84
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For all stock options granted prior to March 1, 2006, the fair value was estimated as of the date of grant using a Black-Scholes option-pricing model. For stock options granted to associates on or after March 1, 2006, the fair value of each award is estimated as of the date of grant using a binomial valuation model. In computing the value of the option, the binomial model considers characteristics of fair-value option pricing that are not available for consideration under the Black-Scholes model, such as the contractual term of the option, the probability that the option will be exercised prior to the end of its contractual life and the probability of termination or retirement of the option holder. For this reason, we believe that the binomial model provides a fair value that is more representative of actual experience and future expected experience than the value calculated using the Black-Scholes model. For grants to nonemployee directors prior to fiscal 2009, we used the Black-Scholes model to estimate the fair value of stock option awards. Beginning in fiscal 2009, we used the binomial model. Estimates of fair value are not intended to predict actual future events or the value ultimately realized by the recipients of share-based awards.

The weighted average fair values at the date of grant for options granted during the three-month periods ended May 31, 2010 and 2009, were \$10.86 and \$5.26 per share, respectively. The unrecognized compensation costs related to nonvested options totaled \$32.7 million as of May 31, 2010. These costs are expected to be recognized over a weighted average period of 2.7 years.

#### ASSUMPTIONS USED TO ESTIMATE OPTION VALUES

	Three Months Ended May 31			
	2010		2009	
Dividend yield	0.0	%	0.0	%
	34.6%	–	54.9%	–
Expected volatility factor (1)	49.8	%	71.5	%
Weighted average expected volatility	48.1	%	57.4	%
	0.2%	–	0.2%	–
Risk-free interest rate (2)	4.0	%	2.5	%
Expected term (in years) (3)	4.7		5.3 – 5.5	

- (1) Measured using historical daily price changes of our stock for a period corresponding to the term of the option and the implied volatility derived from the market prices of traded options on our stock.  
(2) Based on the U.S. Treasury yield curve in effect at the time of grant.  
(3) Represents the estimated number of years that options will be outstanding prior to exercise.



## RESTRICTED STOCK ACTIVITY

(Shares in thousands)	Number of Shares	Weighted Average Grant Date Fair Value
Outstanding as of March 1, 2010	1,663	\$ 22.08
Restricted stock vested	(726 )	\$ 24.97
Restricted stock cancelled	(22 )	\$ 21.06
Outstanding as of May 31, 2010	915	\$ 19.81

We did not grant shares of restricted stock during the first three months of fiscal 2011 or 2010. The fair value of a restricted stock award is determined and fixed based on the fair market value of our stock on the grant date.

We realized related tax benefits of \$7.1 million from the vesting of restricted stock in the first three months of fiscal 2011 and \$3.9 million in the first three months of fiscal 2010. The unrecognized compensation costs related to nonvested restricted stock awards totaled \$4.6 million as of May 31, 2010. These costs are expected to be recognized over a weighted average period of 0.8 years.

## STOCK-SETTLED RESTRICTED STOCK UNIT ACTIVITY

(Units in thousands)	Number of Units	Weighted Average Grant Date Fair Value
Outstanding as of March 1, 2010	395	\$ 16.34
Stock units granted	277	\$ 36.24
Stock units vested and converted	(3 )	\$ 16.34
Stock units cancelled	(2 )	\$ 16.34
Outstanding as of May 31, 2010	667	\$ 24.61

For the three-month periods ended May 31, 2010 and 2009, we granted MSUs of 277,066 units and 405,872 units, respectively. The fixed fair values per share at the date of grant for MSUs granted during the three-month periods ended May 31, 2010 and 2009 were \$36.24 and \$16.34, respectively. The fair values were determined using a Monte-Carlo simulation and were based on the expected market price of our common stock on the vesting date and the expected number of converted common shares. The unrecognized compensation costs related to these nonvested MSUs totaled \$12.0 million as of May 31, 2010. These costs are expected to be recognized over a weighted average period of 2.2 years.

## CASH-SETTLED RESTRICTED STOCK UNIT ACTIVITY

(Units in thousands)	Number of Units	Weighted Average Grant Date Fair Value
Outstanding as of March 1, 2010	916	\$ 11.43
Stock units granted	689	\$ 25.39
Stock units vested and converted	(2 )	\$ 13.30
Stock units cancelled	(22 )	\$ 14.02

Outstanding as of May 31, 2010	1,581	\$	17.48
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During the first three months of fiscal 2011 and 2010, we granted RSUs of 688,880 units and 1,005,505 units, respectively. The initial fair market values per share for the liability-classified RSUs granted during the first three months of fiscal 2011 and 2010 were \$25.39 and \$11.43, respectively. The RSUs will be cash-settled upon vesting.

## EXPECTED CASH SETTLEMENT RANGE UPON RESTRICTED STOCK UNIT VESTING

(In thousands)	As of May 31, 2010	
	Minimum (1)	Maximum (1)
Fiscal 2013	\$ 6,924	\$ 18,464
Fiscal 2014	10,601	28,269
Total expected cash settlements	\$ 17,525	\$ 46,733

(1) Net of estimated forfeitures.

## 11. Net Earnings per Share

Our restricted stock awards are considered participating securities because they contain nonforfeitable rights to dividends and are included in the computation of earnings per share pursuant to the two-class method. Nonvested MSUs and RSUs do not receive nonforfeitable dividend equivalent rights and are therefore not considered participating securities. As RSUs are nonparticipating, non-equity instruments, they are excluded from net earnings per share calculations.

## BASIC AND DILUTIVE NET EARNINGS PER SHARE RECONCILIATIONS

(In thousands except per share data)	Three Months Ended May 31	
	2010	2009
Net earnings	\$ 101,119	\$ 28,748
Less net earnings allocable to restricted stock	536	304
Net earnings available for basic common shares	100,583	28,444
Adjustment for dilutive potential common shares	10	
Net earnings available for diluted common shares	\$ 100,593	\$ 28,444
Weighted average common shares outstanding	222,221	218,004
Dilutive potential common shares:		
Stock options	3,424	835
Stock-settled restricted stock units	534	1
Weighted average common shares and dilutive potential common shares	226,179	218,840
Basic net earnings per share	\$ 0.45	\$ 0.13
Diluted net earnings per share	\$ 0.44	\$ 0.13

For the quarter ended May 31, 2010 and 2009, weighted-average options to purchase 2,776,574 shares and 13,439,076 shares, respectively, of common stock were outstanding and not included in the calculations of diluted net earnings per share because their inclusion would be antidilutive.

## 12. Accumulated Other Comprehensive Loss

(In thousands, net of income taxes)	Unrecognized Actuarial Losses	Unrecognized Hedge Losses	Total
Balance as of February 28, 2010	\$ 19,546	\$	\$ 19,546
Retirement plans:			
Amortization recognized in net pension expense	(29 )		(29 )

## Cash flow hedges:

Effective portion of changes in fair value			859	859
Balance as of May 31, 2010	\$	19,517	\$	859
			\$	20,376

Changes in the funded status of our retirement plans and changes associated with our derivatives designated as accounting hedges are recognized in accumulated other comprehensive loss. The cumulative balances are net of deferred tax of \$12.0 million as of May 31, 2010, and \$11.5 million as of February 28, 2010.

### 13. Contingent Liabilities

On April 2, 2008, Mr. John Fowler filed a putative class action lawsuit against CarMax Auto Superstores California, LLC and CarMax Auto Superstores West Coast, Inc. in the Superior Court of California, County of Los Angeles. Subsequently, two other lawsuits, Leena Areso et al. v. CarMax Auto Superstores California, LLC and Justin Weaver v. CarMax Auto Superstores California, LLC, were consolidated as part of the Fowler case. The allegations in the consolidated case involved: (1) failure to provide meal and rest breaks or compensation in lieu thereof; (2) failure to pay wages of terminated or resigned employees related to meal and rest breaks and overtime; (3) failure to pay overtime; (4) failure to comply with itemized employee wage statement provisions; and (5) unfair competition. The putative class consisted of sales consultants, sales managers, and other hourly employees who worked for the company in California from April 2, 2004, to the present. On May 12, 2009, the court dismissed all of the class claims with respect to the sales manager putative class. On June 16, 2009, the court dismissed all claims related to the failure to comply with the itemized employee wage statement provisions. The court also granted CarMax's motion for summary adjudication with regard to CarMax's alleged failure to pay overtime to the sales consultant putative class. The plaintiffs have appealed the court's ruling regarding the sales consultant overtime claim. In addition to the plaintiffs' appeal of the overtime claim, the claims currently remaining in the lawsuit regarding the sales consultant putative class are: (1) failure to provide meal and rest breaks or compensation in lieu thereof; (2) failure to pay wages of terminated or resigned employees related to meal and rest breaks; and (3) unfair competition. On June 16, 2009, the court entered a stay of these claims pending the outcome of a California Supreme Court case involving related legal issues. The lawsuit seeks compensatory and special damages, wages, interest, civil and statutory penalties, restitution, injunctive relief and the recovery of attorneys' fees. We are unable to make a reasonable estimate of the amount or range of loss that could result from an unfavorable outcome in these matters.

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

### 14. Recent Accounting Pronouncements

In January 2010, the FASB issued an additional accounting pronouncement related to fair value measurement disclosures (FASB ASC Topic 820), which requires fair value hierarchy disclosures to be further disaggregated by class of assets and liabilities. A class is often a subset of assets or liabilities within a line item on the consolidated balance sheets. In addition, significant transfers in and out of Levels 1 and 2 of the fair value hierarchy and the reasons for the transfers will be required to be disclosed. This provision of the pronouncement is effective for reporting periods beginning after December 15, 2009. Accordingly, we adopted the provision as of March 1, 2010, with no significant transfers other than the effects of adopting ASU Nos. 2009-16 and 2009-17. An additional provision, effective for reporting periods beginning after December 15, 2010, requires that the reconciliation of Level 3 activity present information about purchases, sales, issuances and settlements on a gross basis instead of as one net number. If applicable, we will include the additional required disclosures for our fiscal year beginning March 1, 2011.

ITEM 2.

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is provided as a supplement to, and should be read in conjunction with, our audited consolidated financial statements, the accompanying notes and the MD&A included in our Annual Report on Form 10-K for the fiscal year ended February 28, 2010 ("fiscal 2010"), as well as our consolidated financial statements and the accompanying notes included in Item 1 of this Form 10-Q. Note references are to the notes to consolidated financial statements included in Item 1. All references to net earnings per share are to diluted net earnings per share.

In this discussion, "we," "our," "us," "CarMax," "CarMax, Inc." and "the company" refer to CarMax, Inc. and its wholly owned subsidiaries, unless the context requires otherwise. Amounts and percentages in tables may not total due to rounding.

BUSINESS OVERVIEW

General

CarMax is the nation's largest retailer of used vehicles. We pioneered the used car superstore concept, opening our first store in 1993. Our strategy is to revolutionize the auto retailing market by addressing the major sources of customer dissatisfaction with traditional auto retailers and to maximize operating efficiencies through the use of standardized operating procedures and store formats enhanced by sophisticated, proprietary management information systems. As of May 31, 2010, we operated 101 used car superstores in 47 markets, comprised of 35 mid-sized markets, 11 large markets and 1 small market. We define mid-sized markets as those with television viewing populations generally between 600,000 and 2.5 million people. We also operated six new car franchises. In fiscal 2010, we sold 357,129 used cars, representing 98% of the total 364,980 vehicles we sold at retail.

We believe the CarMax consumer offer is distinctive within the automobile retailing marketplace. Our offer provides customers the opportunity to shop for vehicles the same way they shop for items at other "big box" retailers. Our consumer offer is structured around four customer benefits: low, no-haggle prices; a broad selection; high quality vehicles; and a customer-friendly sales process. Our website, carmax.com, is a valuable tool for communicating the CarMax consumer offer, a sophisticated search engine and an efficient channel for customers who prefer to conduct their shopping online. We generate revenues, income and cash flows primarily by retailing used vehicles and associated items including vehicle financing, extended service plans ("ESPs"), a guaranteed asset protection product ("GAP") and vehicle repair service.

We also generate revenues, income and cash flows from the sale of vehicles purchased through our appraisal process that do not meet our retail standards. These vehicles are sold through on-site wholesale auctions. Wholesale auctions are generally held on a weekly or bi-weekly basis, and as of May 31, 2010, we conducted auctions at 50 used car superstores. During fiscal 2010, we sold 197,382 wholesale vehicles. On average, the vehicles we wholesale are approximately 10 years old and have more than 100,000 miles. Participation in our wholesale auctions is restricted to licensed automobile dealers, the majority of whom are independent dealers and licensed wholesalers.

CarMax provides financing to qualified retail customers through CarMax Auto Finance ("CAF"), our finance operation, and a number of third-party financing providers. The third-party provider who purchases subprime financings purchases these loans at a discount, and we collect fixed, prenegotiated fees from the majority of the other

providers. We periodically test additional providers. CarMax has no recourse liability for the financing provided by these third parties.

We sell ESPs and GAP on behalf of unrelated third parties who are the primary obligors. We have no contractual liability to the customer under these third-party products. ESP revenue represents commissions received on the sale of ESPs and GAP from the unrelated third parties.

Over the long term, we believe the primary drivers for earnings growth will be vehicle unit sales growth, from both new stores and stores included in our comparable store base, as well as improvements in margins resulting from operational efficiencies. We target a dollar range of gross profit per used unit sold. The gross profit dollar target for an individual vehicle is based on a variety of factors, including its anticipated probability of sale and its mileage relative to its age; however, it is not primarily based on the vehicle's selling price. Our ability to

quickly adjust appraisal offers to be consistent with the broader market trade-in trends and our rapid inventory turns reduce our exposure to the inherent continual fluctuation in used vehicle values and contribute to our ability to manage gross profit dollars per unit. We employ a volume-based strategy, and we systematically mark down individual vehicle prices based on proprietary pricing algorithms in order to appropriately balance sales trends, inventory turns and gross profit achievement.

As a result of the weak economic and sales environment, in December 2008, we temporarily suspended store growth. This suspension reduced our capital needs and growth-related costs. Based on the improvements in our sales and profitability in fiscal 2010, as well as the increasing stability in the credit markets, we resumed store growth in fiscal 2011. We opened three stores in fiscal 2011 and plan to open between three and five stores in fiscal 2012 and between five and ten stores in fiscal 2013. We are still at a relatively early stage in the national rollout of our retail concept, and as of May 31, 2010, we had used car superstores located in markets that comprised approximately 46% of the U.S. population.

In the near term, our principal challenges are related to the weak economic conditions and the resulting high unemployment rate and relatively low levels of consumer confidence, all of which have contributed to a dramatic decline in industry-wide auto sales, when compared with pre-recessionary levels. Longer term, we believe the principal challenges we face will include our ability to build our management bench strength to support our store growth and our ability to procure suitable real estate at favorable terms. We staff each newly opened store with an experienced management team. Therefore, we must recruit, train and develop managers and associates to fill the pipeline necessary to support future store openings.

#### Fiscal 2011 First Quarter Highlights

- § Net sales and operating revenues increased 23% to \$2.26 billion from \$1.83 billion in the first quarter of fiscal 2010, while net earnings increased 252% to \$101.1 million, or \$0.44 per share, compared with \$28.7 million, or \$0.13 per share, in the prior year period.
- § Total used vehicle revenues increased 18% to \$1.83 billion from \$1.55 billion in the first quarter of fiscal 2010. Comparable store used unit sales increased 9%, reflecting the benefit of a continuing gradual rebound in customer traffic, as well as the easy comparison with the prior year period. Average used vehicle retail selling prices climbed 9%, primarily reflecting increases in our acquisition costs, which have been affected by the year-over-year increase in used vehicle wholesale values.
- § We opened one used car superstore late in the first quarter, entering the Augusta, Georgia, market.
- § Total wholesale vehicle revenues increased 85% to \$316.5 million from \$171.5 million in the prior year quarter. Wholesale vehicle unit sales increased 52%, reflecting significant increases in both appraisal traffic and our appraisal buy rate, as well as the easy year-over-year comparison. Average wholesale vehicle selling prices rose 22% primarily due to the strong wholesale industry pricing trends.
- § Total gross profit increased 21% to \$333.5 million from \$276.2 million in the first quarter of fiscal 2010, reflecting the combination of the increase in unit sales plus an improvement in our total gross profit dollars per retail unit, which increased \$325 to \$3,236 per unit from \$2,911 per unit in the corresponding prior year period.
- § CAF reported income of \$57.5 million compared with a loss of \$21.6 million in the first quarter of fiscal 2010. Results for the prior year period were reduced by adjustments totaling \$40.4 million related to loans originated in previous fiscal periods. CAF income in the first quarter of fiscal 2011 reflected the historically high spreads between interest rates charged to consumers and CAF's funding costs experienced in the more recent term securitizations. In addition, CAF's provision for loan losses in the current year's quarter reflected favorable trends in net charge-offs and a very high recovery rate relative to historical averages. The lower-than-expected losses and the resulting adjustment to the allowance for loan losses related to future periods favorably affected net income by approximately \$0.03 per share versus our expectations.
- §



Selling, general and administrative (“SG&A”) expenses increased 10% to \$226.7 million from \$206.2 million in the prior year quarter, compared with the 23% increase in total revenues. The increase in SG&A primarily reflected the increase in sales commissions and other variable costs associated with the 9% increase in used unit sales, as well as the absence of the \$0.02 per share litigation benefit reported in the prior year quarter. In addition, we modestly increased our advertising spending per unit sold, and we incurred preopening costs in connection with the resumption of store growth this year.

§ In the first quarter of fiscal 2011, \$55.6 million of cash was provided by operating activities, while in the first quarter of fiscal 2010, \$79.4 million of cash was used in operating activities. Several factors contributed to the current period improvement, including the significant increase in net earnings, the reduction in the retained interest in securitized receivables and a more moderate increase in inventory.

#### CRITICAL ACCOUNTING POLICIES

Securitization Transactions. As of March 1, 2010, we adopted ASU Nos. 2009-16 and 2009-17 (formerly Statements of Financial Accounting Standards Nos. 166 and 167, respectively) on a prospective basis. Pursuant to these pronouncements, we now recognize all existing and future transfers of auto loan receivables into term securitizations as secured borrowings,

which results in recording the auto loan receivables and the related non-recourse notes payable to the investors on our consolidated balance sheets. We also account for all transfers of auto loan receivables into our warehouse facilities on or after March 1, 2010, as secured borrowings. As of March 1, 2010, we also amended our warehouse facility agreement in effect as of that date. As a result, the receivables that were funded in the warehouse facility at that date were consolidated, along with the related non-recourse notes payable, at their fair value. Also pursuant to these pronouncements, beginning in fiscal 2011, CAF income included in the consolidated statements of earnings no longer includes a gain on the sale of loans through securitization transactions, but instead primarily reflects the interest and certain other income associated with the auto loan receivables less the interest expense associated with the non-recourse notes payable issued to fund these receivables, direct CAF expenses and a provision for estimated loan losses. See Notes 2, 3 and 4 for additional discussion of securitizations.

For a discussion of our other critical accounting policies, see “Critical Accounting Policies” in MD&A included in Item 7 of the Annual Report on Form 10-K for the fiscal year ended February 28, 2010. These policies relate to revenue recognition and income taxes.

## RESULTS OF OPERATIONS

### NET SALES AND OPERATING REVENUES

(In millions)	Three Months Ended May 31			
	2010	%	2009	%
Used vehicle sales	\$1,832.1	81.0	\$1,549.3	84.5
New vehicle sales	50.9	2.3	48.6	2.6
Wholesale vehicle sales	316.5	14.0	171.5	9.3
Other sales and revenues:				
Extended service plan revenues	41.4	1.8	34.6	1.9
Service department sales	26.3	1.2	26.6	1.5
Third-party finance fees, net	(5.3)	(0.2)	3.8	0.2
Total other sales and revenues	62.5	2.8	65.0	3.5
Total net sales and operating revenues	\$2,261.9	100.0	\$1,834.3	100.0

### RETAIL VEHICLE SALES CHANGES

	Three Months Ended May 31			
	2010		2009	
Vehicle units:				
Used vehicles	9	%	(13)	)%
New vehicles	5	%	(42)	)%
Total	9	%	(14)	)%
Vehicle dollars:				
Used vehicles	18	%	(15)	)%
New vehicles	5	%	(41)	)%
Total	18	%	(16)	)%

Comparable store used unit sales growth is one of the key drivers of our profitability. A store is included in comparable store retail sales in the store’s fourteenth full month of operation.



## COMPARABLE STORE RETAIL VEHICLE SALES CHANGES

	Three Months Ended May 31			
	2010		2009	
Vehicle units:				
Used vehicles	9	%	(17	)%
New vehicles	5	%	(42	)%
Total	8	%	(18	)%
Vehicle dollars:				
Used vehicles	18	%	(19	)%
New vehicles	5	%	(41	)%
Total	18	%	(20	)%

## CHANGE IN USED CAR SUPERSTORE BASE

	Three Months Ended May 31	
	2010	2009
Used car superstores, beginning of period	100	100
Superstore openings	1	
Used car superstores, end of period	101	100

**Used Vehicle Sales.** Our 18% increase in used vehicle revenues in the first quarter of fiscal 2011 resulted from a 9% increase in unit sales combined with a 9% increase in average retail selling price. The 9% increase in comparable store used unit sales was equal to the 9% increase in used unit sales since substantially all of our stores were included in the comparable store base during the first quarter of fiscal 2011. The increase in comparable store unit sales primarily reflected the benefit of a continuing gradual rebound in customer traffic, as well as the easy comparison with the prior year period, when comparable store used unit sales declined 17%. Sales execution remained strong in the first quarter, as our stores were able to maintain the recent gains in the sales conversion rate. The increase in the average retail selling price primarily reflected increases in our acquisition costs, which resulted from the year-over-year increase in used vehicle wholesale values.

**New Vehicle Sales.** Compared with the corresponding prior year period, new vehicle revenues increased 5% in the first quarter of fiscal 2011. The improvement was entirely attributable to an increase in unit sales. Sales volume growth was partially offset by reduced sales volumes at our Chevrolet franchise, which is one of the many franchises being terminated by General Motors. Given the small number of franchises we operate, our new car operations represent only 2% of our total net sales and operating revenues.

**Wholesale Vehicle Sales.** Vehicles acquired through the appraisal purchase process that do not meet our retail standards are sold at our on-site wholesale auctions. The 85% increase in wholesale vehicle revenues in the first quarter of fiscal 2011 resulted from a 52% increase in wholesale unit sales and a 22% increase in average wholesale selling price. The increase in unit sales reflected significant increases in both appraisal traffic and our appraisal buy rate, as well as the easy comparison with the prior year period, when wholesale unit sales declined 25%. We believe the strong industry-wide wholesale vehicle pricing environment and the resulting increases in our appraisal offers had a favorable effect on the buy rate. The improvement in average wholesale selling price reflected the trends in the general wholesale market for the types of vehicles we sell, as well as changes in vehicle mix and the average age,

mileage and condition of the vehicles wholesaled.

Other Sales and Revenues. Other sales and revenues include commissions on the sale of ESPs and GAP, service department sales and net third-party finance fees. In the first quarter of fiscal 2011, other sales and revenues declined 4% from the prior year's quarter. Extended service plan revenues increased 20%, reflecting both the growth in our retail vehicle sales and the fiscal 2010 rollout of GAP. However, this increase was more than offset by the decline in net third-party finance fees. The change in third-party finance fees primarily reflected a mix shift among providers, including a significant increase in the percentage of vehicles financed by our subprime finance provider. The third-party provider who purchases subprime financings purchases these loans at a discount, and subprime finance penetration was approximately 9% of retail unit sales in the first quarter of fiscal 2011 compared with approximately 4% in the prior year period. We believe the increase in subprime penetration was due in part to the tightening of lending standards by our third-party non-prime finance providers over the last year that caused an increased percent of finance applications to be routed to the subprime provider.

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Our previously announced agreement with Santander Consumer USA was renewed on favorable terms. Under this agreement, Santander is purchasing a large portion of the loans that CAF would have originated prior to CAF's tightening of lending standards in 2009. This agreement will now automatically renew for 90-day periods unless terminated in advance by either party.

Seasonality. Historically, our business has been seasonal. Typically, our superstores experience their strongest traffic and sales in the spring and summer quarters. Sales are typically slowest in the fall quarter, when used vehicles generally experience proportionately more of their annual depreciation. We believe this is partly the result of a decline in customer traffic, as well as discounts on model year closeouts that can pressure pricing for late-model used vehicles. Customer traffic generally tends to slow in the fall as the weather changes and as customers shift their spending priorities toward holiday-related expenditures.

#### Supplemental Sales Information.

#### UNIT SALES

	Three Months Ended May 31		Change	
	2010	2009		
Used vehicles	100,925	92,863	9	%
New vehicles	2,134	2,031	5	%
Wholesale vehicles	64,359	42,226	52	%

#### AVERAGE SELLING PRICES

	Three Months Ended May 31		Change	
	2010	2009		
Used vehicles	\$17,964	\$16,489	9	%
New vehicles	\$23,721	\$23,773		%
Wholesale vehicles	\$4,786	\$3,936	22	%

#### RETAIL VEHICLE SALES MIX

	Three Months Ended May 31			
	2010	2009		
Vehicle units:				
Used vehicles	98	%	98	%
New vehicles	2	%	2	%
Total	100	%	100	%
Vehicle dollars:				
Used vehicles	97	%	97	%
New vehicles	3	%	3	%
Total	100	%	100	%

As of May 31, 2010, we operated a total of six new car franchises representing the Chevrolet, Chrysler, Nissan and Toyota brands. In June 2009, we were notified by General Motors that our Chevrolet franchise in Kenosha,

Wisconsin, would be terminated no later than October 2010. By this date, we expect to stop selling new General Motors vehicles at this site, where we also have a used car superstore and a Toyota franchise. We do not expect this franchise termination to have a material effect on sales or earnings.

## GROSS PROFIT

(In millions)	Three Months Ended May 31			
	2010	2009	Change	
Used vehicle gross profit	\$ 223.2	\$ 185.8	20	%
New vehicle gross profit	1.5	\$ 1.1	43	%
Wholesale vehicle gross profit	60.7	\$ 38.2	59	%
Other gross profit	48.1	\$ 51.2	(6)	)%
Total gross profit	\$ 333.5	\$ 276.2	21	%

## GROSS PROFIT PER UNIT

	Three Months Ended May 31					
	2010		2009			
	\$ per unit		\$ per unit			
	(1)	%	(2)	(1)	%	(2)
Used vehicle gross profit	\$2,212	12.2	\$2,001	12.0		
New vehicle gross profit	\$724	3.0	\$532	2.2		
Wholesale vehicle gross profit	\$942	19.2	\$904	22.3		
Other gross profit	\$467	77.0	\$539	78.8		
Total gross profit	\$3,236	14.7	\$2,911	15.1		

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

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

**Used Vehicle Gross Profit.** Our used vehicle gross profit increased 20% to \$223.2 million from \$185.8 million in the first quarter of fiscal 2010, reflecting the combination of an 11% improvement in used vehicle gross profit dollars per unit and the 9% increase in used unit sales. Used vehicle gross profit per unit increased \$211 to \$2,212 per unit compared with \$2,001 per unit in the prior year quarter. The improvement in gross profit per unit resulted from a combination of factors, including a year-over-year increase in the percentage of retail vehicles sourced directly from consumers through our appraisal process, the support provided by the continued strength in wholesale industry valuations, benefits realized from our initiatives to reduce vehicle reconditioning costs and our strong inventory turns.

**New Vehicle Gross Profit.** Our new vehicle gross profit increased to \$1.5 million from \$1.1 million in the first quarter of fiscal 2010, reflecting an improvement in new vehicle gross profit dollars per unit and the 5% increase in new vehicle unit sales. New vehicle gross profit per unit increased \$192 to \$724 per unit from \$532 per unit in the prior year quarter. In the first quarter of last year, our new vehicle gross profit per unit for our two Chrysler franchises was adversely affected by the Chrysler bankruptcy, which resulted in a sharp drop in traffic at this manufacturer's franchises and our decision to cut selling prices and margins in order to reduce our Chrysler new vehicle inventory.

**Wholesale Vehicle Gross Profit.** Our wholesale vehicle gross profit increased 59% to \$60.7 million from \$38.2 million in the first quarter of fiscal 2010, reflecting the combination of the 52% increase in wholesale unit sales and a 4% improvement in wholesale vehicle gross profit dollars per unit. Wholesale vehicle gross profit per unit increased \$38 to \$942 per unit compared with \$904 per unit in the prior year period, primarily reflecting the higher year-over-year wholesale pricing environment. We continued to achieve strong dealer attendance and car-to-dealer



ratios at our wholesale auctions.

**Other Gross Profit.** We have no cost of sales related to ESP and GAP revenues or net third-party finance fees, as these represent commissions paid to us by the third-party providers. In the case of the subprime finance providers, it represents the discount associated with these loans. Other gross profit declined 6% to \$48.1 million from \$51.2 million in the first quarter of fiscal 2010. Other gross profit per unit decreased \$72, or 13%, to \$467 per unit compared with \$539 per unit in the prior year quarter. ESP gross profit benefited from the increase in used unit sales and the contribution from our new GAP product. However, this increase was more than offset by the reduction in net third-party finance fees, which was adversely affected by the mix shift among providers.

**Impact of Inflation.** Historically, inflation has not been a significant contributor to results. Profitability is primarily affected by our ability to achieve targeted unit sales and gross profit dollars per vehicle rather than on average retail prices. However, increases in average vehicle selling prices benefit the SG&A ratio and CAF income, to the extent the average amount financed also increases.

During fiscal 2010, we experienced a period of strong appreciation in used vehicle wholesale pricing. In the first quarter of fiscal 2011, we experienced seasonal appreciation slightly above historical levels. We believe the appreciation resulted, in part, from a reduced supply of used vehicles in the market that was caused by the dramatic decline in new car industry sales and the associated slow down in used vehicle trade-in activity. The appreciation also reflected a rebound in pricing compared with the severe depreciation in wholesale industry pricing experienced in fiscal 2009. The higher wholesale values increased both our vehicle acquisition costs and our average selling prices for used and wholesale vehicles.

CarMax Auto Finance Income (Loss). CAF provides financing for a portion of our used and new car retail sales. Because the purchase of a vehicle is often reliant on the consumer's ability to obtain on-the-spot financing, it is important to our business that financing be available to creditworthy customers. While financing can also be obtained from third-party sources, we believe that total reliance on third parties can create unacceptable volatility and business risk. Furthermore, we believe that our processes and systems, the transparency of our pricing and our vehicle quality provide a unique and ideal environment in which to procure high-quality auto loans, both for CAF and for the third-party financing providers. Generally, CAF has provided us the opportunity to capture additional profits and cash flows from auto loan receivables while managing our reliance on third-party financing sources.

CAF provides financing for qualified customers at competitive market rates of interest. The majority of CAF income has typically been generated by the spread between the interest rates charged to customers and the related cost of funds. Substantially all of the loans originated by CAF are funded through securitization transactions.

As described in the Critical Accounting Policies section of this MD&A, as of March 1, 2010, we adopted ASU Nos. 2009-16 and 2009-17 on a prospective basis. Beginning in fiscal 2011, CAF income no longer includes a gain on the sale of loans through securitization transactions, but instead primarily reflects the interest and certain other income associated with the auto loan receivables less the interest expense associated with the non-recourse notes payable issued to fund these receivables, direct CAF expenses and a provision for estimated loan losses.

#### COMPONENTS OF CAF INCOME (LOSS)

(In millions)	Three Months Ended May 31				
	2010	%	(1)	2009	%
(1)					
Managed portfolio income:					
Interest and fee income	\$99.8	9.7		\$	
Servicing fee income	0.9	0.1		10.4	1.0
Interest income on retained interest in securitized receivables	1.6	0.2		16.4	1.6
Total managed portfolio income	102.3	9.9		26.8	2.7
Gain (loss):					
Gain on sales of loans originated and sold (2)				3.1	0.7
Other gains (losses)	2.6	0.3		(40.4)	)
Total gain (loss)	2.6	0.3		(37.3)	)
Expenses:					
Interest expense	35.2	3.4			
Provision for loan losses	0.9	0.1			
Payroll and fringe benefit expense	5.2	0.5		5.1	0.5
Other direct CAF expenses	6.1	0.6		6.0	0.6
Total expenses	47.4	4.6		11.1	1.1

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CarMax Auto Finance income (loss)	\$57.5	5.6	\$(21.6)	(2.2)
Total average managed receivables, principal only	\$4,123.0		\$4,002.6	
Net loans originated	\$535.4		\$468.5	
Loans originated and sold			\$460.5	

Percent columns indicate:

(1) Annualized percent of total average managed receivables, principal only, except where noted.

(2) Percent of loans originated and sold.

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CAF income does not include any allocation of indirect costs or income. We present this information on a direct basis to avoid making arbitrary decisions regarding the indirect benefits or costs that could be attributed to CAF. Examples of indirect costs not included are retail store expenses and corporate expenses such as human resources, administrative services, marketing, information systems, accounting, legal, treasury and executive payroll.

Fiscal 2011. CAF reported income of \$57.5 million in the first quarter of fiscal 2011. The profit in the first quarter was driven largely by the spread between interest and fee income charged to consumers and our funding costs, as well as favorability in our provision for loan losses.

#### NET INTEREST INCOME

(In millions)	Three Months Ended May 31		
	2010	%	(1)
Interest and fee income	\$99.8	9.7	
Interest expense	(35.2)	(3.4)	)
Net interest income	64.6	6.3	
Provision for loan losses	(0.9)	(0.1)	)
Net interest income after provision for loan losses	\$63.7	6.2	
Total average managed receivables, principal only	\$4,123.0		

(1) Annualized percent of total average managed receivables, principal only.

Net interest income before the provision for loan losses, which reflects the spread between the interest charged to consumers and our funding costs, was 6.3% of total average managed receivables, principal only, in the first quarter. This spread was favorably impacted by the following factors:

- Over the last several quarters the spread between benchmark interest rates and consumer rates has remained wide relative to historical averages. Further, the dramatic improvement in credit spreads in the term securitization market has favorably affected the spread between the interest rates charged to customers and our related cost of funds.
- We typically use interest rate swaps to hedge our interest rate risk while the receivables are in the warehouse facilities and unwind these swaps when the receivables are refinanced in a term securitization. Prior to March 1, 2010, these interest rate swaps were not designated as hedges for accounting purposes. The gain or loss realized on the swap unwinds was recognized in CAF income at the time of the term securitization with a largely offsetting gain or loss in the residual value of the securitized receivables. Because we have been in a declining interest rate environment for several consecutive quarters, we incurred significant cash outflows to unwind these hedges in prior years; however, in the first quarter we benefited from lower funding costs.
- Prior to March 1, 2010, certain securitization costs such as underwriting, rating agency fees and legal expenses were expensed at the time of the securitization. Under the new accounting pronouncements adopted March 1, 2010, these costs are being capitalized and amortized over the term of the related securitizations.

Additionally, as noted below, the provision for loan losses benefited from lower than anticipated net charge-offs in the first quarter of fiscal 2011 and favorable adjustments to the allowance for loan losses.

Servicing fee income and interest income on retained interest in securitized receivables were related to receivables securitized through the warehouse facility prior to March 1, 2010. Other gains or losses in the first quarter of fiscal 2011 primarily reflected favorable derivative valuations.

## ALLOWANCE FOR LOAN LOSSES

(In millions)

Balance as of March 1, 2010	\$58.6	
Net charge-offs	(9.1)	)
Provision for loan losses	0.9	
Balance as of May 31, 2010	\$50.4	
Annualized net charge-offs as a percentage of total average managed receivables, principal only	0.88	%
Ending allowance for loan losses as a percentage of ending managed receivables	1.21	%
Total average managed receivables, principal only	\$4,123.0	
Ending managed receivables	\$4,155.2	

The allowance for loan losses represents an estimate as of the applicable reporting date of the net losses in the loan portfolio anticipated to occur during the following 12 months. The allowance is primarily based on the credit quality of the underlying receivables, historical loss trends and forecasted forward loss curves. We also take into account recent trends in delinquencies and losses, recovery rates and the underlying economic environment. The provision for loan losses is the periodic cost of maintaining an adequate allowance. The allowance for loan losses as of March 1, 2010, was established as a part of adopting ASU No. 2009-16.

The decrease in the allowance from \$58.6 million, or 1.4% of ending managed receivables, as of March 1, 2010, to \$50.4 million, or 1.2% of ending managed receivables, as of May 31, 2010, reflected the favorable trends in net charge-offs and the record high recovery rate relative to historical norms. Net charge-offs in the first quarter were significantly lower than both our projections and prior year trends. The lower-than-expected losses and the resulting adjustment to the provision for loan losses related to future periods favorably affected net income in the first quarter of fiscal 2011 by approximately \$0.03 per share versus our expectations.

Fiscal 2010. Prior to March 1, 2010, securitization transactions were accounted for as sales. A gain, recorded at the time of securitization, resulted from recording a receivable approximately equal to the present value of the expected residual cash flows generated by the securitized receivables. The gain on sales of loans originated and sold included both the gain income recorded at the time of securitization and the effect of any subsequent changes in valuation assumptions or funding costs that were incurred in the same fiscal period that the loans were originated. Other losses included the effects of changes in valuation assumptions or funding costs related to loans originated and sold during previous fiscal periods. In addition, other losses included the effects of new term securitizations, changes in the valuation of retained subordinated bonds and the repurchase and resale of receivables in existing term securitizations, as applicable. Other income consisted of servicing fee income on securitized receivables and interest income. Interest income included the effective yield on the retained interest, as well as interest income earned on retained subordinated bonds.

CAF reported a loss of \$21.6 million in the first quarter of fiscal 2010. These CAF results were reduced by \$40.4 million of adjustments related to loans originated in previous fiscal periods. These adjustments included:

- A \$57.6 million reduction related to increased funding costs for the \$1.22 billion of auto loan receivables that were funded in the warehouse facility at the end of fiscal 2009. This amount included the increase in funding costs for the \$1 billion of auto loan receivables that were refinanced in a term securitization in April 2009, as well as our estimate of the increase in funding cost for the remaining \$215 million of receivables that were still in the warehouse facility at the end of the first quarter.

- \$17.2 million of favorable adjustments, including \$12.3 million of favorable mark-to-market adjustments on retained subordinated bonds, decreases in prepayment rate assumptions and minor revisions to other assumptions.

Excluding these adjustments CAF income was \$18.8 million in the first quarter of fiscal 2010. CAF's gain on sales of loans originated and sold was \$3.1 million in the first quarter of fiscal 2010 reflecting a higher estimated cost of funding in the warehouse facility, a decline in loan origination volume, and the use of a 19% discount rate assumption.

In the first quarter in fiscal 2010, we anticipated that the warehouse facility funding costs would increase when the facility was renewed or replaced in July 2009. We reflected these estimated higher warehouse costs in the gain recognized on all loans originated and sold in the first quarter of fiscal 2010, as well as the \$215 million of loans originated in prior periods which remained in the warehouse facility as of May 31, 2009.

## PAST DUE ACCOUNT INFORMATION

(In millions)	As of May 31		As of February 28	
	2010	2009	2010	2009
Ending managed receivables	\$4,155.2	\$4,040.9	\$4,112.7	\$3,986.7
Accounts 31+ days past due	\$133.0	\$125.6	\$133.2	\$118.1
Past due accounts as a percentage of ending managed receivables	3.20	% 3.11	% 3.24	% 2.96

## CREDIT LOSS INFORMATION

(In millions)	Three Months Ended May 31			
	2010		2009	
Net credit losses on managed receivables	\$9.1		\$12.7	
Total average managed receivables, principal only	\$4,123.0		\$4,002.6	
Annualized net credit losses as a percentage of total average managed receivables, principal only	0.88	%	1.27	%
Average recovery rate	55.7	%	48.5	%

Past due accounts as a percentage of ending managed receivables were comparable to the same period in fiscal 2010. Annualized net credit losses as a percentage of total average managed receivables, principal only, decreased significantly compared to the first quarter of the prior year. We believe the decrease was the result of several factors including our credit tightening implemented in fiscal 2010 and strong recovery rates.

The average recovery rate represents the average percentage of the outstanding principal balance we receive when a vehicle is repossessed and liquidated at wholesale auction. Historically, the annual recovery rate has ranged from a low of 42% to a high of 51%, and it is primarily affected by changes in the wholesale market pricing environment.

**Selling, General and Administrative Expenses.** SG&A expenses increased 10% to \$226.7 million from \$206.2 million in the prior year's first quarter, compared with the 23% increase in total revenues. The increase in SG&A primarily reflected the increase in sales commissions and other variable costs associated with the 9% increase in used unit sales, as well as the absence of the \$0.02 per share litigation benefit reported in the prior year quarter. In addition, we modestly increased our advertising spending per unit sold, and we incurred preopening costs in connection with the resumption of store growth in fiscal 2011. The SG&A ratio improved to 10.0% in the first quarter of fiscal 2011 compared with 11.2% in the prior year quarter, reflecting the leverage associated with the increases in both average selling prices and unit sales.

**Income Taxes.** The effective income tax rate was 38.5% in the first quarter of fiscal 2011 compared with 39.5% in the first quarter of fiscal 2010. The higher effective tax rate in fiscal 2010 was primarily due to an increase in tax reserves in that year.

## OPERATIONS OUTLOOK

**Planned Superstore Openings.** During the first quarter of fiscal 2011, we opened one used car superstore, entering the Augusta, Georgia, market. In mid-June 2010, we opened the two remaining new stores planned for fiscal 2011, in Cincinnati and Dayton, Ohio. All three of these stores were constructed in fiscal 2009, but we chose not to open them



until market conditions improved. We currently plan to open between three and five stores in fiscal 2012 and between five and ten stores in fiscal 2013.

**Capital Expenditures.** We currently estimate gross capital expenditures will total approximately \$90 million in fiscal 2011. Compared with the \$22.4 million of capital spending in fiscal 2010, the increase in planned fiscal 2011 expenditures reflects real estate acquisitions and construction costs associated with the resumption of store growth, as well as information technology and reconditioning equipment upgrades.

**Fiscal 2011 Expectations.** At the beginning of fiscal 2011, we provided one-time guidance on CAF income in order to assist investors with the transition in the securitization accounting rules. However, we will neither be providing nor updating this guidance on a going-forward basis, as is consistent with our current earnings guidance practice.

## FINANCIAL CONDITION

**Liquidity and Capital Resources.** The combined effects of the adoption of ASU Nos. 2009-16 and 2009-17 and the March 1, 2010, amendment to our existing warehouse facility agreement represent non-cash transactions, and thus the reported cash flow information for the first quarter of fiscal 2011 takes into account the effect of these and other related reclassifications and adjustments.

**Operating Activities.** In the first quarter of fiscal 2011, \$55.6 million of cash was provided by operating activities, while in the first quarter of fiscal 2010, \$79.4 million of cash was used in operating activities. Several factors contributed to the current period improvement, including the significant increase in net earnings, the reduction in the retained interest in securitized receivables and a more moderate increase in inventory.

The retained interest in securitized receivables declined by \$43.7 million during the first quarter of fiscal 2011 compared with an increase of \$85.0 million during the first quarter of fiscal 2010. In May 2010, we repurchased the remaining portion of the receivables that were funded in the existing warehouse facility as of March 1, 2010, and we resecuritized them through our second warehouse facility established in the first quarter of fiscal 2011. As a result, the retained interest related to these receivables was either eliminated or reclassified. The increase in fiscal 2010 was primarily the result of our retaining subordinated bonds in the April 2009 term securitization. In conjunction with the change in accounting for securitized receivables, as of March 1, 2010, we consolidated the auto loan receivables, net of an allowance for loan losses, on our consolidated balance sheets. The net auto loan receivables increased by \$93.8 million during the first quarter of fiscal 2011, reflecting the combination of an increase in managed receivables during this period and the reclassification of amounts previously included in the retained interest in securitized receivables.

As of May 31, 2010, total inventory was \$894.7 million, representing an increase of \$51.5 million, or 6%, compared with the balance at the start of the fiscal year. This increase in inventory reflected a 5% increase in used vehicle units in inventory compared with February 28, 2010, combined with the rise in vehicle acquisition costs resulting from the appreciation in wholesale vehicle values. The increase in used vehicle inventory units included additional units to support the 9% comparable store used unit sales growth, as well as the store openings in May and mid-June 2010. As of May 31, 2009, total inventory was \$781.1 million, representing an increase of \$77.9 million, or 11%, compared with the balance at the start of that fiscal year. This increase reflected our below-target inventory level at the start of fiscal 2010, a sequential improvement in customer traffic and sales in the first quarter of fiscal 2010 compared with the fourth quarter of fiscal 2009 and rising vehicle acquisition costs.

We utilize derivative instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the values of which are determined by interest rates. Prior to March 1, 2010, no derivative instruments were designated as accounting hedges, as we believed this treatment was best aligned with our use of gain-on-sale accounting. In conjunction with the adoption of the new accounting for securitized receivables as of the beginning of fiscal 2011, we have begun to enter into derivative instruments designated as cash flow hedges of interest rate risk, as we believe this treatment is better aligned with our current accounting policies.

**Investing Activities.** In the first quarter of fiscal 2011, \$4.3 million of cash was provided by investing activities, while in the first quarter of fiscal 2010, \$5.4 million of cash was used in investing activities. Capital expenditures in both periods were relatively minor, reflecting the temporary suspension of store growth between December 2008 and the start of fiscal 2011. We incurred no material capital expenditures in the first quarter of fiscal 2011 related to the three stores opened in May and June 2010, as these stores were originally constructed in fiscal 2009. In the first quarter of fiscal 2011, cash provided by investing activities included the benefit of a net reduction in various restricted cash balances of \$13.5 million.

Historically, capital expenditures have been funded with internally generated funds, long-term debt and sale-leaseback transactions. As of May 31, 2010, we owned 43 superstores currently in operation, the 2 superstores that were opened in June 2010 and our home office in Richmond, Virginia. In addition, five superstores were accounted for as capital leases.

Financing Activities. During the first quarter of fiscal 2011, net cash used in financing activities totaled \$64.5 million, including a reduction in total debt of \$72.2 million. During the first quarter of fiscal 2010, net cash provided by financing activities totaled \$77.8 million, including an increase in total debt of \$80.5 million.

As of May 31, 2010, we had total debt of \$3.90 billion, consisting of \$58.6 million outstanding under our revolving credit facility, \$27.9 million of capitalized leases and \$3.82 billion of non-recourse notes payable issued in connection with the securitized auto loan receivables. Our securitizations are structured to legally isolate the auto loan receivables, and we would not expect to be able to access the assets of our securitization vehicles, even in insolvency, receivership or conservatorship proceedings. We do, however, continue to have the

rights associated with our retained interests in these securitization vehicles. Similarly, the investors in the non-recourse notes payable have no recourse to our assets beyond the securitized receivables, the amounts on deposit in reserve accounts and the restricted cash from collections on auto loan receivables.

We have a \$700 million revolving credit facility, which expires in December 2011 and is secured by our vehicle inventory. Borrowings under this credit facility are limited to 80% of qualifying inventory, and they are available for working capital and general corporate purposes. As of May 31, 2010, based on then-current inventory levels, we had additional borrowing capacity of \$616.7 million under the credit facility. The outstanding balance as of May 31, 2010, included \$0.2 million classified as short-term debt and \$58.4 million classified as current portion of long-term debt. We classified \$58.4 million as current portion of long-term debt based on our expectation that this balance will not remain outstanding for more than one year.

As of May 31, 2010, the total warehouse facility limit was \$1.2 billion. At that date, \$795.0 million of auto loan receivables were funded in the warehouse facilities and unused warehouse capacity totaled \$405.0 million. During the first quarter of fiscal 2011, we entered into a second warehouse facility in order to stagger the warehouse facility renewal dates, reduce risk and provide greater flexibility. As of May 31, 2010, \$800 million of the warehouse facility limit will expire in August 2010 and \$400 million will expire in February 2011. We anticipate that we will be able to enter into new, or renew or expand, existing funding arrangements to meet CAF's future funding needs. However, based on conditions in the credit markets, the cost for these arrangements could be materially higher than historical levels and the timing and capacity of these transactions could be dictated by market availability rather than our requirements. Notes 4 and 9 include additional discussion of the warehouse facilities.

We had cash and cash equivalents of \$13.7 million as of May 31, 2010, compared with \$133.6 million as of May 31, 2009. Starting in the second half of fiscal 2009, we believed it was prudent to maintain a cash balance in excess of our operating requirements due to the unprecedented conditions in the credit markets. Given the subsequent stabilization in the financial sector, we elected to resume maintaining a more normalized cash level starting in the latter half of fiscal 2010.

We expect that cash generated by operations and proceeds from securitization transactions or other funding arrangements, sale-leaseback transactions and borrowings under existing or expanded credit facilities will be sufficient to fund capital expenditures and working capital for the foreseeable future.

**Fair Value Measurements.** We report money market securities, retained interest in securitized receivables and derivative instruments at fair value. See Note 6 for more information on fair value measurements.

## FORWARD-LOOKING STATEMENTS

We caution readers that the statements contained in this report about our future business plans, operations, opportunities, or prospects, including without limitation any statements or factors regarding expected sales, margins or earnings, are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements are based upon management's current knowledge and assumptions about future events and involve risks and uncertainties that could cause actual results to differ materially from anticipated results. We disclaim any intent or obligation to update these statements. Among the factors that could cause actual results and outcomes to differ materially from those contained in the forward-looking statements are the following:

- § Changes in general U.S. or regional U.S. economic conditions.
- § Changes in the availability or cost of capital and working capital financing, including the availability and cost of financing auto loan receivables.
  - § Changes in consumer credit availability related to our third-party financing providers.
  - § Changes in the competitive landscape within our industry.
  - § Significant changes in retail prices for used or new vehicles.
  - § A reduction in the availability or access to sources of inventory.
  - § Factors related to the regulatory and legislative environment in which we operate.
- § The loss of key employees from our store, regional and corporate management teams.
  - § The failure of key information systems.
- § The effect of new accounting requirements or changes to U.S. generally accepted accounting principles.
- § Security breaches or other events that result in the misappropriation, loss or other unauthorized disclosure of confidential customer information.
- § Factors related to geographic growth, including the inability to acquire or lease suitable real estate at favorable terms or to effectively manage our growth.
  - § The effect of various litigation matters.
- § Adverse conditions affecting one or more automotive manufacturers.
  - § The occurrence of severe weather events.
  - § Factors related to seasonal fluctuations in our business.
- § Factors related to the geographic concentration of our superstores.
  - § The occurrence of certain other material events.

For more details on factors that could affect expectations, see Part II, Item 1A. "Risk Factors" on page 38 of this report, our Annual Report on Form 10-K for the fiscal year ended February 28, 2010, and our quarterly or current reports as filed with or furnished to the Securities and Exchange Commission ("SEC"). Our filings are publicly available on our investor information home page at [investor.carmax.com](http://investor.carmax.com). Requests for information may also be made to our Investor Relations Department by email to [investor\\_relations@carmax.com](mailto:investor_relations@carmax.com) or by calling 1-804-747-0422, ext. 4287.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no material changes to our market risk since February 28, 2010. For a discussion of our exposure to market risk, refer to Part II, Item 7A. “Quantitative and Qualitative Disclosures about Market Risk,” contained in our Annual Report on Form 10-K for the year ended February 28, 2010.

Item 4. Controls and Procedures

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

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

Internal Control over Financial Reporting. There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during the quarter ended May 31, 2010, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

On April 2, 2008, Mr. John Fowler filed a putative class action lawsuit against CarMax Auto Superstores California, LLC and CarMax Auto Superstores West Coast, Inc. in the Superior Court of California, County of Los Angeles. Subsequently, two other lawsuits, Leena Areso et al. v. CarMax Auto Superstores California, LLC and Justin Weaver v. CarMax Auto Superstores California, LLC, were consolidated as part of the Fowler case. The allegations in the consolidated case involved: (1) failure to provide meal and rest breaks or compensation in lieu thereof; (2) failure to pay wages of terminated or resigned employees related to meal and rest breaks and overtime; (3) failure to pay overtime; (4) failure to comply with itemized employee wage statement provisions; and (5) unfair competition. The putative class consisted of sales consultants, sales managers, and other hourly employees who worked for the company in California from April 2, 2004, to the present. On May 12, 2009, the court dismissed all of the class claims with respect to the sales manager putative class. On June 16, 2009, the court dismissed all claims related to the failure to comply with the itemized employee wage statement provisions. The court also granted CarMax's motion for summary adjudication with regard to CarMax's alleged failure to pay overtime to the sales consultant putative class. The plaintiffs have appealed the court's ruling regarding the sales consultant overtime claim. In addition to the plaintiffs' appeal of the overtime claim, the claims currently remaining in the lawsuit regarding the sales consultant putative class are: (1) failure to provide meal and rest breaks or compensation in lieu thereof; (2) failure to pay wages of terminated or resigned employees related to meal and rest breaks; and (3) unfair competition. On June 16, 2009, the court entered a stay of these claims pending the outcome of a California Supreme Court case involving related legal issues. The lawsuit seeks compensatory and special damages, wages, interest, civil and statutory penalties, restitution, injunctive relief and the recovery of attorneys' fees. We are unable to make a reasonable estimate of the amount or range of loss that could result from an unfavorable outcome in these matters.

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

### Item 1A. Risk Factors

In connection with information set forth in this Form 10-Q, the factors discussed under "Risk Factors" in our Form 10-K for fiscal year ended February 28, 2010, should be considered. These risks could materially and adversely affect our business, financial condition, and results of operations. There have been no material changes to the factors discussed in our Form 10-K.

### Item 6. Exhibits

10.1 Amendment No. 3 to the Credit Agreement, dated May 12, 2010, by and among CarMax, Inc., CarMax Auto Superstores, Inc., various subsidiaries of CarMax, various Lenders named therein, and Bank of America N.A., as Administrative Agent, filed herewith.

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

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

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

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





SIGNATURES

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

CARMAX, INC.

By: /s/ Thomas J. Folliard  
Thomas J. Folliard  
President and  
Chief Executive Officer

By: /s/ Keith D. Browning  
Keith D. Browning  
Executive Vice President and  
Chief Financial Officer

July 12, 2010

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EXHIBIT INDEX

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