

STRATUS PROPERTIES INC  
Form 10-Q  
November 09, 2007

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended September 30, 2007**

**or**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File Number: 0-19989**

**Stratus Properties Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**72-1211572**

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

**98 San Jacinto Blvd., Suite 220**

**Austin, Texas**

(Address of principal executive offices)

**78701**

(Zip Code)

**(512) 478-5788**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer o

Accelerated filer

R

Non-accelerated filer o

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

On September 30, 2007, there were issued and outstanding 7,543,952 shares of the registrant's Common Stock, par value \$0.01 per share.

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STRATUS PROPERTIES INC.  
Part I. FINANCIAL INFORMATION

Item 1. Financial Statements

STRATUS PROPERTIES INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)  
(In Thousands)

	September 30, 2007	December 31, 2006
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 1,475	\$ 1,620
Restricted cash	1,611	116
Accounts receivable	1,183	839
Deposits, prepaid expenses and other	430	82
Deferred tax asset	1,789	1,144
Discontinued operations	33,747	34,917
Total current assets	40,235	38,718
Real estate, commercial leasing assets and facilities, net:		
Property held for sale – developed or under development	126,320	116,865
Property held for sale – undeveloped	16,444	16,345
Property held for use, net	24,673	18,874
Investment in Crestview	3,925	3,800
Deferred tax asset	6,728	7,105
Other assets	2,266	2,243
Total assets	\$ 220,591	\$ 203,950
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 8,417	\$ 5,676
Accrued interest, property taxes and other	4,225	5,134
Current portion of long-term debt	2,000	-
Discontinued operations	24,689	24,678
Total current liabilities	39,331	35,488
Long-term debt	40,000	28,000
Other liabilities	5,934	6,516
Total liabilities	85,265	70,004
Stockholders' equity:		
Preferred stock	-	-
Common stock	81	81
Capital in excess of par value of common stock	191,084	188,873
Accumulated deficit	(42,021)	(42,655)
Common stock held in treasury	(13,818)	(12,353)
Total stockholders' equity	135,326	133,946
Total liabilities and stockholders' equity	\$ 220,591	\$ 203,950

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

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STRATUS PROPERTIES INC.  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)  
(In Thousands, Except Per Share Amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
<b>Revenues:</b>				
Real estate	\$ 7,002	\$ 7,934	\$ 16,745	\$ 50,686
Rental income	766	389	2,146	1,117
Commissions, management fees and other	268	746	1,249	1,296
<b>Total revenues</b>	<b>8,036</b>	<b>9,069</b>	<b>20,140</b>	<b>53,099</b>
<b>Cost of sales:</b>				
Real estate, net	5,662	5,633	10,651	24,864
Rental	860	483	2,391	1,198
Depreciation	411	204	894	577
<b>Total cost of sales</b>	<b>6,933</b>	<b>6,320</b>	<b>13,936</b>	<b>26,639</b>
General and administrative expenses	1,526	1,518	5,340	5,140
<b>Total costs and expenses</b>	<b>8,459</b>	<b>7,838</b>	<b>19,276</b>	<b>31,779</b>
<b>Operating (loss) income</b>	<b>(423)</b>	<b>1,231</b>	<b>864</b>	<b>21,320</b>
Interest expense, net	-	(3)	(13)	(267)
Interest income	36	102	572	304
(Loss) income from continuing operations before income taxes	(387)	1,330	1,423	21,357
Benefit from (provision for) income taxes	74	12	(557)	8,304
(Loss) income from continuing operations	(313)	1,342	866	29,661
(Loss) income from discontinued operations (including net gain on 7000 West sale of \$7,264 in the 2006 nine-month period)	(32)	(161)	(232)	7,470
<b>Net (loss) income</b>	<b>\$ (345)</b>	<b>\$ 1,181</b>	<b>\$ 634</b>	<b>\$ 37,131</b>
<b>Basic net (loss) income per share of common stock:</b>				
Continuing operations	\$ (0.04)	\$ 0.18	\$ 0.11	\$ 4.07
Discontinued operations	(0.01)	(0.02)	(0.03)	1.02
<b>Basic net (loss) income per share of common stock</b>	<b>\$ (0.05)</b>	<b>\$ 0.16</b>	<b>\$ 0.08</b>	<b>\$ 5.09</b>
<b>Diluted net (loss) income per share of common stock:</b>				
Continuing operations	\$ (0.04)	\$ 0.18	\$ 0.11	\$ 3.87
Discontinued operations	(0.01)	(0.02)	(0.03)	0.98
<b>Diluted net (loss) income per share of common stock</b>	<b>\$ (0.05)</b>	<b>\$ 0.16</b>	<b>\$ 0.08</b>	<b>\$ 4.85</b>
<b>Average shares of common stock outstanding:</b>				
Basic	7,560	7,317	7,559	7,288
Diluted	7,560	7,617	7,640	7,658

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

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STRATUS PROPERTIES INC.  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)  
(In Thousands)

	Nine Months Ended September 30,	
	2007	2006
Cash flow from operating activities:		
Net income	\$ 634	\$ 37,131
Adjustments to reconcile net income to net cash provided by operating activities:		
Loss (income) from discontinued operations	232	(7,470)
Depreciation	894	577
Cost of real estate sold	10,163	20,112
Deferred income taxes	(267)	(8,305)
Stock-based compensation	1,020	894
Excess tax benefit from exercised stock options	(642)	-
Deposits	(1,044)	155
(Increase) decrease in restricted cash	(1,495)	271
Other	(335)	(414)
(Increase) decrease in working capital:		
Accounts receivable and prepaid expenses	(16)	(148)
Accounts payable, accrued liabilities and other	2,571	1,390
Net cash provided by continuing operations	11,715	44,193
Net cash provided by (used in) discontinued operations	1,586	(4,412)
Net cash provided by operating activities	13,301	39,781
Cash flow from investing activities:		
Purchases and development of real estate properties	(27,007)	(12,911)
Development of commercial leasing properties and other expenditures	(1,771)	(8,848)
Municipal utility district reimbursements	2,557	1,337
Investment in Crestview	(125)	-
Net cash used in continuing operations	(26,346)	(20,422)
Net cash (used in) provided by discontinued operations	(113)	2,275
Net cash used in investing activities	(26,459)	(18,147)
Cash flow from financing activities:		
Borrowings from revolving credit facility	17,450	15,000
Payments on revolving credit facility	(18,450)	(30,677)
Borrowings from unsecured term loans	15,000	-
Borrowings from project loans	-	1,214
Repayments on project loans	-	(15,904)
Net proceeds from exercised stock options	13	917
Excess tax benefit from exercised stock options	642	-
Purchases of Stratus common shares	(1,118)	(542)
Bank credit facility fees	-	(421)
Net cash provided by (used in) continuing operations	13,537	(30,413)
Net cash (used in) provided by discontinued operations	(232)	12,814

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Net cash provided by (used in) financing activities	13,305	(17,599)
Net increase in cash and cash equivalents	147	4,035
Cash and cash equivalents at beginning of year	1,839	1,514
Cash and cash equivalents at end of period	1,986	5,549
Less cash at discontinued operations	(511)	(548)
Cash and cash equivalents at end of period	\$ 1,475	\$ 5,001

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

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**STRATUS PROPERTIES INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**1. GENERAL**

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto for the year ended December 31, 2006, included in Stratus Properties Inc.'s (Stratus) Annual Report on Form 10-K (Stratus 2006 Form 10-K) filed with the Securities and Exchange Commission. In the opinion of management, the accompanying condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring items) considered necessary for a fair statement of the financial position of Stratus at September 30, 2007, and the results of operations for the three-month and nine-month periods ended September 30, 2007 and 2006, and cash flows for the nine-month periods ended September 30, 2007 and 2006. Operating results for the three-month and nine-month periods ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. Certain prior year amounts have been reclassified to conform to the current year presentation.

**2. EARNINGS PER SHARE**

Stratus' basic net (loss) income per share of common stock was calculated by dividing the (loss) income from continuing operations, (loss) income from discontinued operations and net (loss) income by the weighted average number of common shares outstanding during the period. The following is a reconciliation of net income and weighted average common shares outstanding for purposes of calculating diluted net (loss) income per share (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
(Loss) income from continuing operations	\$ (313)	\$ 1,342	\$ 866	\$ 29,661
(Loss) income from discontinued operations	(32)	(161)	(232)	7,470
Net (loss) income	\$ (345)	\$ 1,181	\$ 634	\$ 37,131
Weighted average common shares outstanding	7,560	7,317	7,559	7,288
Add: Dilutive stock options	-	271	67	330
Restricted stock	-	29	14	40
Weighted average common shares outstanding for purposes of calculating diluted net (loss) income per share	7,560	7,617	7,640	7,658
Diluted net (loss) income per share of common stock:				
Continuing operations	\$ (0.04)	\$ 0.18	\$ 0.11	\$ 3.87
Discontinued operations	(0.01)	(0.02)	(0.03)	0.98
Diluted net (loss) income per share of common stock	\$ (0.05)	\$ 0.16	\$ 0.08	\$ 4.85

Stock options representing 98,000 shares and restricted stock representing 23,000 shares in the third quarter of 2007 that otherwise would have been included in the third-quarter 2007 earnings per share calculations were excluded because of the net loss reported for the third quarter of 2007.

**3. DEBT OUTSTANDING**

At September 30, 2007, Stratus had total debt of \$42.0 million, including \$2.0 million of current debt, compared to total debt of \$28.0 million at December 31, 2006. Stratus' debt outstanding at September 30, 2007 consisted of the following:

- \$2.0 million of borrowings under the \$45.0 million Comerica revolving credit facility which will mature on May 30, 2008.
- \$40.0 million of borrowings outstanding under seven unsecured term loans, including two \$5.0 million loans, two \$8.0 million loans, a \$7.0 million loan and two \$3.5 million loans, all of which will mature in December 2011.

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On June 1, 2007, Stratus entered into three separate loan agreements with First American Asset Management (FAAM). Pursuant to the loan agreements, additional borrowings totaled \$15.0 million, \$10.6 million of which was used to pay down the outstanding amounts under Stratus' revolving credit facility with Comerica Bank, and the remainder was used for operations, capital expenditures and other development costs, including the Block 21 project. The loans mature in December 2011.

The loan agreements contain customary financial covenants and other restrictions. Except in certain events related to a change in control of Stratus, the loans may not be prepaid prior to December 31, 2007. Beginning on January 1, 2008, the loans may be prepaid subject to certain reinvestment charges as further described in the related promissory notes. The annual interest rate under the loan agreements is 6.915 percent. Repayments under the loan agreements can be accelerated upon the occurrence of certain customary events of default. Stratus' obligations under the loan agreements are unsecured.

For a further discussion of Stratus' debt see Note 4 of the Stratus 2006 Form 10-K.

#### 4. RESTRICTED CASH, INTEREST COST AND STOCK-BASED COMPENSATION

**Restricted Cash.** Restricted cash totaled \$1.6 million at September 30, 2007 of which \$1.5 million represented funds from lot sales held for payment on the Comerica revolving credit facility in October 2007. The remaining \$0.1 million of restricted cash at September 30, 2007 and restricted cash of \$0.1 million at December 31, 2006 represent funds held for payment of fractional shares resulting from the May 2001 stock split (see Note 6 of the Stratus 2006 Form 10-K).

**Interest Cost.** Interest expense excludes capitalized interest of \$0.7 million in the third quarter of 2007, \$0.3 million in the third quarter of 2006, \$2.1 million in the first nine months of 2007 and \$1.2 million in the first nine months of 2006.

**Stock-Based Compensation.** Stock-based compensation costs are capitalized as appropriate. Compensation cost charged against earnings for stock-based awards is shown below (in thousands).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Stock options awarded to employees (including directors)	\$ 153	\$ 167	\$ 388	\$ 449
Stock options awarded to nonemployees	-	-	-	2
Restricted stock units	156	111	821	681
Less capitalized amounts	(48)	(63)	(189)	(238)
Impact on (loss) income from continuing operations before income taxes	\$ 261	\$ 215	\$ 1,020	\$ 894

Stock options representing 45,625 shares at a weighted average option price of \$7.87 per share were exercised in the first nine months of 2007. The tax benefit realized for the tax deductions from stock option exercises totaled \$0.7 million for the nine months ended September 30, 2007 and \$0.9 million for the nine months ended September 30, 2006. Upon exercise of stock options and vesting of restricted stock units, employees may tender Stratus shares to Stratus to pay the exercise price and/or the minimum required taxes. Shares tendered to Stratus for these purposes totaled approximately 32,500 shares for the nine months ended September 30, 2007. Stratus paid \$0.1 million of employee taxes for stock options in the nine months ended September 30, 2007. Stratus granted 38,000 restricted stock units in the nine months ended September 30, 2007, at a grant date fair value of \$1.3 million.

In September 2007, Stratus granted 7,500 stock options under its existing stock option plan for non-employee directors. The fair value of each option award is estimated on the date of grant using a Black-Scholes option valuation model. Expected volatility is based on the historical volatility of Stratus' stock. Stratus uses historical data to estimate option exercises, forfeitures and expected life of the options. When appropriate, employees who have similar historical exercise behavior are grouped for valuation purposes. The risk-free interest rate is based on Federal Reserve rates in effect for bonds with maturity dates equal to the expected term of the option at the date of grant. Stratus has not paid, and has no current plan to pay, cash dividends on its common stock. The assumptions used to value stock option

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awards during the nine months ended September 30, 2007 and September 30, 2006 are noted in the following table:

	2007	2006
Options granted	7,500	7,500
Grant-date fair value per stock option	\$ 16.30	\$ 14.57
Expected and weighted average volatility	41.8%	48.6%
Expected life of options (in years)	6.7	6.7
Risk-free interest rate	4.4%	4.7%

For more information regarding Stratus' stock-based awards see Notes 1 and 6 of the Stratus 2006 Form 10-K.

**5. DISCONTINUED OPERATIONS**

(Loss) income from discontinued operations reported in the condensed consolidated statements of operations included the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Escarpment Village	\$ (49)	\$ (77)	\$ (357)	\$ (147)
7000 West	-	-	-	10,202
(Loss) income before income taxes from discontinued operations	(49)	(77)	(357)	10,055
Benefit from (provision for) income taxes	17	(84)	125	(2,585)
(Loss) income from discontinued operations	\$ (32)	\$ (161)	\$ (232)	\$ 7,470

**Escarpment Village.** On October 12, 2007, Stratus sold the Escarpment Village shopping center, located in Austin, Texas, to Lake Villa, L.L.C. (the Purchaser) for \$46.5 million, before closing costs and other adjustments. The Purchaser paid approximately \$23.0 million in cash at closing and assumed the \$22.4 million principal balance remaining under Stratus' loan from Teachers Insurance and Annuity Association of America (TIAA). Stratus intends to use the net proceeds from the sale for debt reduction and general corporate purposes. Stratus expects to record a pre-tax gain of approximately \$16.5 million on the sale in the fourth quarter of 2007.

Upon completion of the sale of Escarpment Village, Stratus ceased all involvement with the Escarpment Village shopping center. The results of operations, assets and liabilities of Escarpment Village, which have been classified as discontinued operations in the accompanying condensed consolidated financial statements, previously represented a component of Stratus' commercial leasing segment.

The table below provides a summary of Escarpment Village's results of operations for the three-month and nine-month periods ended September 30, 2007 and 2006 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Rental income	\$ 825	\$ 781	\$ 2,582	\$ 1,316
Rental property costs	(375)	(227)	(1,271)	(414)
Depreciation	(154)	(254)	(680)	(466)
General and administrative expenses	(38)	(65)	(71)	(65)
Interest expense <sup>a</sup>	(328)	(332)	(987)	(538)

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Interest income		21		20		70		20
Benefit from income taxes		17		-		125		-
Loss from discontinued operations	\$	(32)	\$	(77)	\$	(232)	\$	(147)

- a. Relates to interest expense from the Escarpment Village project loan and the Escarpment Village loan from TIAA and does not include any additional allocations of interest.

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The following summarizes Escarpment Village's net assets at September 30, 2007 and December 31, 2006 (in thousands):

	September 30, 2007	December 31, 2006
Assets:		
Cash and cash equivalents	\$ 511	\$ 219
Current assets	3,142	3,713
Property held for use, net of accumulated depreciation of \$1,407 and \$727, respectively	26,405	27,828
Long-term assets	3,689	3,157
<b>Total assets</b>	<b>\$ 33,747</b>	<b>\$ 34,917</b>
Liabilities:		
Current portion of long-term debt	\$ (325)	\$ (311)
Other current liabilities	(2,138)	(1,468)
Long-term debt	(22,119)	(22,364)
Other long-term liabilities	(107)	(535)
<b>Total liabilities</b>	<b>\$ (24,689)</b>	<b>\$ (24,678)</b>

7000 West. On March 27, 2006, Stratus' wholly owned subsidiary, Stratus 7000 West Joint Venture (7000 West JV), sold its two 70,000-square-foot office buildings at 7000 West William Cannon Drive (7000 West), known as the Lantana Corporate Center, to CarrAmerica Lantana, LP (CarrAmerica) for \$22.3 million, resulting in a gain of \$9.8 million (\$7.3 million net of taxes or \$1.00 per basic share and \$0.95 per diluted share) in the first nine months of 2006. CarrAmerica paid \$10.6 million cash to Stratus at closing and assumed the \$11.7 million principal balance remaining under Stratus' 7000 West project loan.

Upon completion of the sale of 7000 West, Stratus ceased all involvement with the 7000 West office buildings. The results of operations, assets and liabilities of 7000 West previously were reflected as a component of Stratus' commercial leasing segment.

The table below provides a summary of 7000 West's results of operations for the three-month and nine-month periods ended September 30, 2006 (in thousands):

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Rental income	\$ -	\$ 1,057
Rental property costs	-	(403)
General and administrative expenses	-	(48)
Interest expense <sup>a</sup>	-	(168)
Interest income	-	2
Gain on sale	-	9,762
Provision for income taxes	(84) <sup>b</sup>	(2,585)
(Loss) income from discontinued operations	\$ (84)	\$ 7,617

- a. Relates to interest expense from 7000 West project loan and does not include any additional allocations of interest.  
b. Reflects the allocation of Stratus' third-quarter 2006 tax provision to discontinued operations in accordance with income tax accounting rules.

7500 Rialto Boulevard. In the second quarter of 2007, Stratus committed to a plan to sell its two 75,000-square-foot office buildings at 7500 Rialto Boulevard (7500 Rialto), and as a result, classified all related operating results and assets and liabilities as discontinued operations. However, in the third quarter of 2007, Stratus decided to cease its marketing efforts to sell 7500 Rialto in light of recent changes in credit market conditions. Accordingly, the 2007 and 2006 periods present results of operations and assets and liabilities of 7500 Rialto as part of Stratus' continuing operations and as a component of its commercial leasing segment.

For a further discussion of Stratus' discontinued operations see Note 7 of the Stratus 2006 Form 10-K.

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Stratus has two operating segments, "Real Estate Operations" and "Commercial Leasing." The Real Estate Operations segment is comprised of all Stratus' developed properties, properties under development and undeveloped properties in Austin, Texas, which consist of its properties in the Barton Creek community, the Circle C community and Lantana. The Deerfield property in Plano, Texas, is also included in the Real Estate Operations segment.

The Commercial Leasing segment primarily includes the two office buildings at 7500 Rialto. On October 12, 2007, Stratus sold Escarpment Village and its operating results are reported as discontinued operations for the periods in the table shown below (see Note 5). Stratus sold the two office buildings at 7000 West in March 2006 and their operating results are reported as discontinued operations for the 2006 periods (see Note 5).

Stratus' lease agreement with the anchor tenant of Escarpment Village and its contract with Trammell Crow Central Texas, Ltd. (Trammell Crow), the firm managing Escarpment Village, contained provisions that required Stratus to share the net profits from a sale of the project. The anchor tenant and Trammell Crow were each entitled to 10 percent of any net profit from a sale of Escarpment Village after Stratus received a 12 percent return on its investment. Stratus paid the anchor tenant its net profits interest in December 2006 based upon a hypothetical sale at fair market value. Stratus paid Trammell Crow its net profits interest totaling \$1.1 million upon the sale of Escarpment Village in October 2007.

The segment data presented below were prepared on the same basis as Stratus' consolidated financial statements.

	Real Estate Operations <sup>a</sup>	Commercial Leasing	Other	Total
	(In Thousands)			
<u>Three Months Ended September 30,</u>				
<u>2007</u>				
Revenues	\$ 7,270	\$ 766	\$ -	\$ 8,036
Cost of sales, excluding depreciation	(5,662)	(860)	-	(6,522)
Depreciation	(45)	(366)	-	(411)
General and administrative expenses	(1,345)	(181)	-	(1,526)
Operating (loss) income	\$ 218	\$ (641)	\$ -	\$ (423)
Loss from discontinued operations	\$ -	\$ (32)	\$ -	\$ (32)
Benefit from income taxes	\$ 74	\$ -	\$ -	\$ 74
Capital expenditures	\$ 9,859	\$ 1,528	\$ -	\$ 11,387
Total assets	\$ 150,030	\$ 61,688 <sup>b</sup>	\$ 8,873 <sup>c</sup>	\$ 220,591
<u>Three Months Ended September 30,</u>				
<u>2006</u>				
Revenues	\$ 8,680	\$ 389	\$ -	\$ 9,069
Cost of sales, excluding depreciation	(5,633)	(483)	-	(6,116)
Depreciation	(29)	(175)	-	(204)
General and administrative expense	(1,425)	(93)	-	(1,518)
Operating (loss) income	\$ 1,593	\$ (362)	\$ -	\$ 1,231
Loss from discontinued operations	\$ -	\$ (161)	\$ -	\$ (161)
Benefit from income taxes	\$ 12	\$ -	\$ -	\$ 12
Capital expenditures	\$ 6,327	\$ 3,391	\$ -	\$ 9,718
Total assets	\$ 124,481	\$ 56,743 <sup>b</sup>	\$ 8,342 <sup>c</sup>	\$ 189,566

Nine Months Ended September 30,2007

Revenues	\$	17,994	\$	2,146	\$	-	\$	20,140
Cost of sales, excluding depreciation		(10,651)		(2,391)		-		(13,042)
Depreciation		(115)		(779)		-		(894)
General and administrative expenses		(4,653)		(687)		-		(5,340)
Operating (loss) income	\$	2,575	\$	(1,711)	\$	-	\$	864
Loss from discontinued operations	\$	-	\$	(232)	\$	-	\$	(232)
Provision for income taxes	\$	(557)	\$	-	\$	-	\$	(557)
Capital expenditures	\$	27,007	\$	1,771	\$	-	\$	28,778

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	Real Estate Operations <sup>a</sup>	Commercial Leasing	Other	Total
	(In Thousands)			
<u>Nine Months Ended September 30,</u>				
<u>2006</u>				
Revenues	\$ 51,982	\$ 1,117	\$ -	\$ 53,099
Cost of sales, excluding depreciation	(24,864)	(1,198)	-	(26,062)
Depreciation	(96)	(481)	-	(577)
General and administrative expense	(4,728)	(412)	-	(5,140)
Operating (loss) income	\$ 22,294	\$ (974)	\$ -	\$ 21,320
Income from discontinued operations	\$ -	\$ 7,470 <sup>d</sup>	\$ -	\$ 7,470
Benefit from income taxes	\$ 8,304	\$ -	\$ -	\$ 8,304
Capital expenditures	\$ 12,911	\$ 8,848	\$ -	\$ 21,759

- a. Includes sales commissions, management fees and other revenues together with related expenses.
- b. Includes assets from the discontinued operations of Escarpment Village, which Stratus sold on October 12, 2007, totaling \$33.7 million, net of accumulated depreciation of \$1.4 million, at September 30, 2007, and \$35.0 million, net of accumulated depreciation of \$0.5 million, at September 30, 2006 (see Note 5).
- c. Includes deferred tax assets resulting from the reversal of a portion of Stratus' deferred tax asset valuation allowance which was recorded as a benefit from income taxes (see Note 7).
- d. Includes a \$7.3 million gain, net of taxes of \$2.5 million, on the sale of 7000 West.

## 7. INCOME TAXES

Stratus' deferred tax assets at December 31, 2005 totaled \$19.5 million. At the time, Stratus had provided a 100 percent valuation allowance because realization of the deferred tax assets was not considered likely. Realization of Stratus' deferred tax assets is dependent on generating sufficient taxable income within the carryforward period available under tax law. In March 2006, Stratus sold 7000 West (see Note 5) and in April 2006, Stratus completed the sale of 58 acres at Lantana. These transactions generated pre-tax income of approximately \$26 million and, along with Stratus' current homebuilder contract arrangements and projected levels of future sales, provide sufficient evidence that Stratus will more likely than not be able to realize all of its deferred tax assets. As a result, income from continuing operations for the first nine months of 2006 included an \$8.3 million, \$1.14 per basic share and \$1.08 per diluted share, tax benefit resulting from the reversal of a portion of Stratus' deferred tax asset valuation allowance. Stratus' provision for income taxes for the nine months ended September 30, 2007 totaled \$0.6 million, \$0.08 per share.

Effective January 1, 2007, Stratus adopted Financial Accounting Standards Board (FASB) Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN 48). FIN 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition issues. The adoption of FIN 48 had no material effect on Stratus' financial statements. Stratus will recognize interest accrued related to unrecognized tax benefits in interest expense and penalties in non-operating expenses.

Stratus files income tax returns in the U.S. federal jurisdiction and various state and local jurisdictions. With few exceptions, Stratus is no longer subject to U.S. federal or state and local income tax examinations by tax authorities for the years prior to 2003. In completing its routine audit of Stratus' Texas Franchise Tax account in September 2007, the Texas Comptroller of Public Accounts noted that no additional taxes were due from Stratus.

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**8. NEW ACCOUNTING STANDARDS**

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, "Fair Value Measurements." SFAS No. 157 establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), clarifies the definition of fair value within that framework, and expands disclosures about the use of fair value measurements. In many of its pronouncements, the FASB has previously concluded that fair value information is relevant to the users of financial statements and has required (or permitted) fair value as a measurement objective. However, prior to the issuance of this statement, there was limited guidance for applying the fair value measurement objective in GAAP. This statement does not require any new fair value measurements in GAAP. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007, with early adoption allowed. Stratus is still reviewing the provisions of SFAS No. 157 and has not determined the impact of adoption.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Liabilities – Including an amendment of FASB No. 115." SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. This statement is effective for fiscal years beginning after November 15, 2007, with early adoption allowed. Stratus has not yet determined the impact, if any, that adopting this standard might have on its financial statements.

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REVIEW BY INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The financial information as of September 30, 2007, and for the three-month and nine-month periods ended September 30, 2007 and 2006, included in Part I of this Form 10-Q pursuant to Rule 10-01 of Regulation S-X has been reviewed by PricewaterhouseCoopers LLP (PricewaterhouseCoopers), Stratus' independent registered public accounting firm, in accordance with the standards of the Public Company Accounting Oversight Board (United States). PricewaterhouseCoopers' report is included in this quarterly report.

PricewaterhouseCoopers does not carry out significant or additional procedures beyond those that would have been necessary if its report had not been included in this quarterly report. Accordingly, such report is not a "report" or "part of a registration statement" within the meaning of Sections 7 and 11 of the Securities Act of 1933 and the liability provisions of Section 11 of such Act do not apply.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders  
of Stratus Properties Inc.:

We have reviewed the accompanying condensed consolidated balance sheet of Stratus Properties Inc. and its subsidiaries as of September 30, 2007 and the related condensed consolidated statements of operations for each of the three-month and nine-month periods ended September 30, 2007 and 2006 and the condensed consolidated statements of cash flows for the nine-month periods ended September 30, 2007 and 2006. These interim financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We previously audited in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2006, and the related consolidated statements of income, of changes in stockholders' equity and of cash flows for the year then ended (not presented herein), and in our report dated March 15, 2007, we expressed an unqualified opinion on those consolidated financial statements with an explanatory paragraph for the Company's change in accounting for stock-based compensation. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet information as of December 31, 2006, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

**/s/ PricewaterhouseCoopers LLP**

Austin, Texas  
November 9, 2007

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

**OVERVIEW**

*Management's discussion and analysis presented below should be read in conjunction with our discussion and analysis of financial results contained in our 2006 Annual Report on Form 10-K (2006 Form 10-K). The operating results summarized in this report are not necessarily indicative of our future operating results. All subsequent references to Notes refer to Notes to Condensed Consolidated Financial Statements, unless otherwise stated.*

We are engaged in the acquisition, development, management and sale of commercial, multi-family and residential real estate properties located primarily in the Austin, Texas area. We conduct real estate operations on properties we own.

Our principal real estate holdings are currently in southwest Austin, Texas. As of September 30, 2007, our most significant holding is the 1,678 acres of residential, multi-family and commercial property and 30 developed residential estate lots located within the Barton Creek community. We also own approximately 350 acres of undeveloped commercial property and approximately 36 acres of commercial property under development within the Circle C Ranch (Circle C) community. Our other properties in the Circle C community currently include Meridian, which is an 800-lot residential development. At September 30, 2007, Meridian consisted of approximately 249 acres and 90 developed residential lots. Our remaining Austin holdings at September 30, 2007, consisted of 223 acres of commercial property and two 75,000-square-foot office buildings at 7500 Rialto Boulevard (7500 Rialto) located in Lantana. On October 12, 2007, we sold Escarpment Village, which is a 168,000-square-foot retail center anchored by a grocery store, for \$46.5 million, before closing costs and other adjustments. Accordingly, we have reported Escarpment Village's assets, liabilities and results of operations as discontinued operations.

At September 30, 2007, our Deerfield property, which is located in Plano, Texas, consists of approximately eight acres of residential land, which is being developed, and 19 developed residential lots. We also own two acres of undeveloped commercial property in San Antonio, Texas.

In November 2005, we formed a joint venture with Trammell Crow Central Texas Development, Inc. (Trammell Crow) to acquire an approximate 74-acre tract at the intersection of Airport Boulevard and Lamar Boulevard in Austin, Texas for \$7.7 million. The property, known as Crestview Station, is a single-family, multi-family, retail and office development. With Trammell Crow, we have commenced brown field remediation and permitting of the property.

In December 2006, we acquired a city block in downtown Austin for \$15.1 million. The project, known as Block 21, is planned for a mixture of retail, hotel, residential, and entertainment uses on approximately two acres as more fully discussed in "Development and Other Activities."

**BUSINESS STRATEGY**

Our financial condition and results of operations are highly dependent upon market conditions in Austin. Our future operating cash flows and, ultimately, our ability to develop our properties and expand our business will be largely dependent on the level of our real estate sales. In turn, these sales will be significantly affected by future real estate market conditions in Austin, Texas, development costs, interest rate levels and regulatory issues including our land use and development entitlements. From 2001 through 2004, a downturn in the technology sector negatively affected the Austin real estate market, especially the high-end residential and commercial leasing markets; however, beginning in 2005, market conditions have improved.

Over the past several years, we have successfully worked cooperatively with the City of Austin (the City) to obtain approvals that allow the development of our properties to proceed in a timely manner while protecting the environment. We believe the desirable location and overall quality of our properties, in combination with the land use and development entitlements we have obtained, will command a premium over the value of other Austin-area properties.

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Our long-term success will depend on our ability to maximize the value of our real estate through obtaining required approvals that permit us to develop and sell our properties in a timely manner at a reasonable cost. We must incur significant development expenditures and secure additional permits prior to the development and sale of certain properties. In addition, we continue to pursue additional development opportunities, and believe we can obtain bank financing for developing our properties at a reasonable cost. See “Risk Factors” located in Item 1A. of our 2006 Form 10-K.

As previously announced, we were exploring strategic alternatives for enhancing shareholder value, including a possible sale of the company. We retained JPMorgan as our financial advisor to assist in this process. We have terminated the process of exploring the possible sale of the company but expect to continue to review various alternatives to enhance shareholder value.

### **DEVELOPMENT AND OTHER ACTIVITIES**

*Block 21.* In April 2005, the City selected our proposal to develop a mixed-use project in downtown Austin immediately north of the new City Hall complex. The project includes an entire city block and is planned for a mixture of retail, hotel, residential and entertainment uses. In December 2006, we acquired the property for \$15.1 million. We have executed agreements with Starwood Hotels & Resorts Worldwide, Inc. for the development of a W Hotel and Residences on the site. On May 8, 2007, we announced our partnership with Canyon-Johnson Urban Fund II, L.P., a joint venture between the Los Angeles-based Canyon Capital Realty Advisors and Earvin "Magic" Johnson, for the development of Block 21. We have begun the permitting process with the City and the grand opening for the onsite sales center was held in conjunction with the groundbreaking ceremony in October 2007.

*Lantana.* Lantana is a partially developed, mixed-use project with remaining entitlements for approximately 1.0 million square feet of office and retail use on 223 acres as of September 30, 2007. Regional utility and road infrastructure is in place with capacity to serve Lantana at full build-out permitted under our existing entitlements.

In September 2006, we completed a second 75,000-square-foot office building at 7500 Rialto in response to increased demand for office space within Lantana. As of September 30, 2007, we had leased approximately 94 percent of the space at the second office building and the original office building is fully leased.

*Barton Creek Community.* Since January 2002, we have secured subdivision plat approval for three new residential subdivisions within the Barton Creek Community, including: Versant Place – 54 lots, Wimberly Lane Phase II – 47 lots and Calera – 155 lots. At September 30, 2007, our remaining unsold developed lots within the Barton Creek Community included: Calera Drive – 8 lots, Wimberly Lane Phase II – 5 lots, Calera Court – 7 lots and Mirador – 3 lots. Development of the remaining Barton Creek property is expected to occur over several years.

In 2004, we entered into a contract with a national homebuilder to sell 41 lots within the Wimberly Lane Phase II subdivision in the Barton Creek community. The homebuilder paid us a non-refundable \$0.6 million deposit for the right to purchase the 41 lots. The deposit was used to pay ongoing development costs of the lots. The deposit will be applied against subsequent purchases of lots by the homebuilder after certain thresholds are achieved and will be recognized as income as lots are sold. The lots are being sold on a scheduled takedown basis, with the initial six lots sold in December 2004 following completion of subdivision utilities, and then an average of three lots per quarter beginning in June 2005. The average purchase price for each of the 41 lots is \$150,400, subject to a six percent annual escalator commencing in December 2004.

During 2004, we began construction of courtyard homes at Calera Court within the Barton Creek community. Calera Court, the initial phase of the “Calera” subdivision, will include 16 homesites on 16 acres. The second phase of Calera, Calera Drive, consisting of 53 single-family lots, many of which adjoin the Fazio Canyons Golf Course, received final

plat and construction permit approval in 2005. In the third quarter of 2005, development of these lots was completed and the initial lots were sold. As of September 30, 2007, only eight lots remained unsold at Calera Drive. Development of the final phase, known as Verano Drive, will include 71 single-family lots. Construction of the final phase of Calera began in the first quarter of 2007 and is scheduled for completion in December 2007.

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In the second quarter of 2007, we completed the first phase of the Barton Creek Village. The first phase includes a 22,000-square-foot retail building. In July 2007, we began construction of a 3,300-square-foot bank building within this retail complex. Construction of the second retail building will begin by early 2008.

*Circle C Community.* We are developing the Circle C community based on the entitlements secured in our Circle C settlement with the City. Our Circle C settlement, as amended in 2004, permits development of 1.16 million square feet of commercial space, 504 multi-family units and 830 single family residential lots. Meridian is an 800-lot residential development at the Circle C community. In January 2005, the first phase of construction commenced. During the first quarter of 2005, we contracted to sell a total of 494 lots in our Meridian project to three national homebuilders in four phases. Sales for each of the four phases commence upon substantial completion of development for that phase, and continue every quarter until all of the lots have been sold. The first and second phases each consisted of 134 lots. The first phase was substantially completed at the end of 2005. Development of the second phase was substantially completed in March 2006. Development of the 108-lot third phase of Meridian was completed in September 2007. The 118-lot fourth phase will commence in 2008 and completion is expected by the end of 2008.

In 2006, we signed another contract with a national homebuilder for 42 additional lots. Development of those lots commenced in April 2007 and substantial completion is expected in November 2007. Development of the final phase of Meridian, which consists of 57 one-acre lots, is expected to commence in 2008.

We estimate our sales from the first three phases of Meridian will total at least 46 lots for \$3.0 million during the fourth quarter of 2007.

*Deerfield.* In January 2004, we acquired the Deerfield property in Plano, Texas, for \$7.0 million. The property was zoned and subject to a preliminary subdivision plan for 234 residential lots. We executed agreements with a national homebuilder, whereby the homebuilder paid us \$1.4 million for an option to purchase all 234 lots over 36 monthly take-downs. The net purchase price for each of the 234 lots was \$61,500, subject to certain terms and conditions. The \$1.4 million option payment is non-refundable, but will be applied against subsequent purchases of lots by the homebuilder after certain thresholds are achieved and will be recognized by us as income as lots are sold. We agreed to pay up to \$5.2 million of the homebuilder's development costs. The homebuilder must pay all property taxes and maintenance costs. The initial lot sale occurred in November 2004 and subsequent lot sales are on schedule. In October 2005, we executed a revised agreement with the homebuilder, increasing the lot sizes and average purchase price to \$67,150 based on a new total of 224 lots. We expect 15 lot sales for \$1.0 million to be completed during the fourth quarter of 2007.

*Crestview Station.* In November 2005, we formed a joint venture with Trammell Crow to acquire an approximate 74-acre tract at the intersection of Airport Boulevard and Lamar Boulevard in Austin, Texas, for \$7.7 million. With Trammell Crow, we have commenced brown field remediation and permitting of the property, known as Crestview Station, which is located on the commuter rail line approved by City of Austin voters. Crestview Station is planned for single-family, multi-family and retail development, with closings on the retail and multi-family components expected to occur in 2007. At September 30, 2007, our investment in the Crestview Station project totaled \$3.9 million and the joint venture partnership had \$7.6 million of outstanding debt, of which each joint venture partner guarantees \$1.9 million.

Our joint venture partnership has contracted with a nationally recognized remediation firm to demolish the existing buildings and remediate the property in preparation for permitting. Under the terms of the remediation contract, the joint venture partnership will pay the contractor approximately \$4.9 million upon completion of performance benchmarks and certification by the State of Texas that the remediation is complete. The contractor is required to pay all costs associated with the remediation and to maintain an environmental liability policy with \$10.0 million of coverage remaining in place for a 10-year term. Pursuant to the agreement with the contractor, all environmental and

legal liability was assigned to and assumed by the contractor effective November 30, 2005. In September 2007, the State of Texas certified that the remediation was complete.

Table of Contents**RESULTS OF OPERATIONS**

We are continually evaluating the development potential of our properties and will continue to consider opportunities to enter into significant transactions involving our properties. As a result, and because of numerous other factors affecting our business activities as described herein, our past operating results are not necessarily indicative of our future results.

Summary operating results follow (in thousands):

	Third Quarter		Nine Months	
	2007	2006	2007	2006
Revenues:				
Real estate operations	\$ 7,270	\$ 8,680	\$ 17,994	\$ 51,982
Commercial leasing	766	389	2,146	1,117
Total revenues	\$ 8,036	\$ 9,069	\$ 20,140	\$ 53,099
Operating (loss) income	\$ (423)	\$ 1,231	\$ 864	\$ 21,320
Benefit from (provision for) income taxes	\$ 74	\$ 12	\$ (557)	\$ 8,304
(Loss) income from continuing operations	\$ (313)	\$ 1,342	\$ 866	\$ 29,661
(Loss) income from discontinued operations	(32)	(161)	(232)	7,470
Net (loss) income	\$ (345)	\$ 1,181	\$ 634	\$ 37,131

Our deferred tax assets at December 31, 2005 totaled \$19.5 million and we had provided a 100 percent valuation allowance because realization of the deferred tax assets was not considered likely. Realization of our deferred tax assets is dependent on generating sufficient taxable income within the carryforward period available under tax law. In March 2006, we sold 7000 West (see Note 5) and in April 2006, we completed the sale of 58 acres at our Lantana property. These transactions generated pre-tax income of approximately \$26 million and, along with our current homebuilder contract arrangements and projected levels of future sales, provide sufficient evidence that we will more likely than not be able to realize all of our deferred tax assets. As a result, income from continuing operations for the first nine months of 2006 included an \$8.3 million, \$1.14 per basic share and \$1.08 per diluted share, tax benefit resulting from the reversal of a portion of our deferred tax asset valuation allowance.

We have two operating segments, "Real Estate Operations" and "Commercial Leasing" (see Note 6). The following is a discussion of our operating results by segment.

**Real Estate Operations**

Summary real estate operating results follow (in thousands):

	Third Quarter		Nine Months	
	2007	2006	2007	2006
Revenues:				
Developed property sales	\$ 7,002	\$ 7,934	\$ 15,662	\$ 28,441
Undeveloped property sales	-	-	1,083	22,245
Commissions, management fees and other	268	746	1,249	1,296
Total revenues	7,270	8,680	17,994	51,982

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Cost of sales, including depreciation	(5,707)	(5,662)	(10,766)	(24,960)
General and administrative expenses	(1,345)	(1,425)	(4,653)	(4,728)
Operating income	\$ 218	\$ 1,593	\$ 2,575	\$ 22,294

*Developed Property Sales.* Property sales for the third-quarter and nine-month periods of 2007 and 2006 included the following (revenues in thousands):

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	Third Quarter			
	2007		2006	
	Lots	Revenues	Lots	Revenues
<i>Residential Properties:</i>				
Barton Creek				
Calera Drive	-	\$ -	5	\$2,065
Calera Court Courtyard Homes	1	657	1	610
Mirador Estate	-	-	1	553
<i>Wimberly Lane Phase II</i>				
Standard Homebuilder	3	516	4	686
Amarra Drive Phase I	1	1,250	-	-
<i>Circle C</i>				
Meridian	58	3,575	51	3,013
Deerfield	15	1,004	15	1,007
Total Residential	78	\$7,002	77	\$7,934

	Nine Months			
	2007		2006	
	Lots	Revenues	Lots	Revenues
<i>Residential Properties:</i>				
Barton Creek				
Calera Drive	2	\$809	23	\$9,919
Calera Court Courtyard Homes	1	657	5	2,922
Mirador Estate	2	1,559	6	3,306
<i>Wimberly Lane Phase II</i>				
Standard Homebuilder	9	1,561	9	1,469
Amarra Drive Phase I	1	1,250	-	-
<i>Circle C</i>				
Meridian	106	6,814	133	7,804
Deerfield	45	3,012	45	3,021
Total Residential	166	\$15,662	221	\$28,441

*Undeveloped Property Sales.* We sold a five-acre tract at Circle C for \$1.1 million during the first quarter of 2007 and a 7.5-acre tract in the Barton Creek community for \$1.5 million during the first quarter of 2006. In April 2006, we sold a 58-acre tract at Lantana for \$21.2 million of which \$0.5 million represented a reimbursement of certain costs, which was recorded as a reduction of cost of sales.

*Commissions, Management Fees and Other.* Commissions, management fees and other revenues decreased in the 2007 periods compared to the 2006 periods primarily because of the decrease in sales activity.

*Cost of Sales.* Cost of sales for the first nine months of 2007 included reductions totaling \$1.7 million for Barton Creek Municipal Utility District (MUD) reimbursements. Cost of sales for the 2007 nine-month period also decreased compared to the 2006 nine-month period primarily because of a decrease in developed property sales in the 2007

period.

**Commercial Leasing**

Our commercial leasing operating results primarily reflect the activities at 7500 Rialto. In September 2006, we completed construction of a second 75,000-square-foot office building at 7500 Rialto. As of September 30, 2007, the original office building was fully leased and the second building was approximately 94 percent leased. The completion of the second building and the increase in its occupancy resulted in higher revenues in the 2007 periods, compared to the 2006 periods.

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Summary commercial leasing operating results follow (in thousands):

	Third Quarter		Nine Months	
	2007	2006	2007	2006
Rental income	\$ 766	\$ 389	\$ 2,146	\$ 1,117
Rental property costs	(860)	(483)	(2,391)	(1,198)
Depreciation	(366)	(175)	(779)	(481)
General and administrative expenses	(181)	(93)	(687)	(412)
Operating loss	\$ (641)	\$ (362)	\$ (1,711)	\$ (974)

**Other Financial Results**

General and administrative expenses increased to \$5.3 million in the first nine months of 2007 from \$5.1 million in the first nine months of 2006, primarily because of higher compensation costs.

**Non-Operating Results**

Interest income totaled \$0.6 million in the first nine months of 2007, compared with \$0.3 million in the first nine months of 2006, primarily reflecting interest on MUD reimbursements totaling approximately \$0.5 million in the first quarter of 2007.

**DISCONTINUED OPERATIONS**

On October 12, 2007, we sold the Escarpment Village shopping center, located in Austin, Texas, to Lake Villa, L.L.C. (the Purchaser) for \$46.5 million, before closing costs and other adjustments. The Purchaser paid approximately \$23.0 million in cash at closing and assumed the \$22.4 million principal balance remaining under our loan from Teachers Insurance and Annuity Association of America (TIAA). We intend to use the net proceeds from the sale for debt reduction and general corporate purposes. We expect to record a pre-tax gain of approximately \$16.5 million on the sale in the fourth quarter of 2007.

Upon completion of the sale of Escarpment Village, we ceased all involvement with the Escarpment Village shopping center. The results of operations, assets and liabilities of Escarpment Village, which have been classified as discontinued operations in the condensed consolidated financial statements, previously represented a component of our commercial leasing segment. We earned rental income from Escarpment Village totaling \$0.8 million in the third quarter of 2007, \$0.8 million in the third quarter of 2006, \$2.6 million in the first nine months of 2007 and \$1.3 million in the first nine months of 2006.

On March 27, 2006, our wholly owned subsidiary, Stratus 7000 West Joint Venture (7000 West JV), sold its two 70,000-square-foot office buildings at 7000 West William Cannon Drive (7000 West), known as the Lantana Corporate Center, to CarrAmerica Lantana, LP (CarrAmerica) for \$22.3 million, resulting in a gain of \$9.8 million (\$7.3 million net of taxes or \$1.00 per basic share and \$0.95 per diluted share) in the first nine months of 2006. CarrAmerica paid us \$10.6 million cash at closing and assumed the \$11.7 million principal balance remaining under our 7000 West project loan.

Upon completion of the sale of 7000 West, we ceased all involvement with the 7000 West office buildings. The operations, assets and liabilities of 7000 West represented a component of our commercial leasing segment. We earned rental income of \$1.1 million in the first nine months of 2006 from the two fully leased office buildings at 7000 West.

Our discontinued operations generated net (losses) income of less than \$(0.1) million in the third quarter of 2007, \$(0.2) million in the third quarter of 2006, \$(0.2) million in the first nine months of 2007 and \$7.5 million, including a \$7.3 million gain net of taxes on the 7000 West sale, in the first nine months of 2006.

### **CAPITAL RESOURCES AND LIQUIDITY**

#### **Comparison of Nine-Months 2007 and 2006 Cash Flows**

Operating activities provided cash of \$13.3 million during the first nine months of 2007 and \$39.8 million during the first nine months of 2006, including cash provided by discontinued operations totaling \$1.6 million during the 2007 period and cash used in discontinued operations totaling \$4.4 million during the

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2006 period. Compared to the 2006 period, operating cash flows in the first nine months of 2007 were reduced primarily because of the decrease in sales activities.

Cash used in investing activities totaled \$26.5 million during the first nine months of 2007 and cash used in investing activities totaled \$18.1 million during the first nine months of 2006. Expenditures for real estate properties in the 2007 nine-month period primarily related to development costs for the Block 21 project (see “Development and Other Activities”). Expenditures for real estate properties for the nine-month periods of 2007 and 2006 also included development costs for properties in the Barton Creek and Circle C communities (see “Development and Other Activities”). Expenditures for commercial leasing properties for the first nine months of 2007 primarily related to the first retail building at Barton Creek Village and for the first nine months of 2006 primarily related to the second building at 7500 Rialto, which was completed in September 2006 (see “Development and Other Activities”). We received Barton Creek municipal utility district reimbursements totaling \$2.6 million in the first nine months of 2007 and \$1.3 million in the first nine months of 2006. Investing cash flows provided by discontinued operations in the 2006 nine-month period included \$10.0 million received from the sale of 7000 West partly offset by \$7.7 million of capital expenditures on the construction of Escarpment Village which opened in May 2006 (see “Discontinued Operations”).

Financing activities provided cash of \$13.3 million during the first nine months of 2007, compared to \$17.6 million of cash used in financing activities during the first nine months of 2006. Our financing activities in the first nine months of 2007 include \$15.0 million of borrowings under our three new unsecured term loans and \$1.0 million of net repayments on our revolving line of credit. In the first nine months of 2007, we also used \$1.1 million to repurchase shares of our common stock on the open market (see below). During the first nine months of 2006, our financing activities included \$15.7 million of net repayments on our revolving line of credit and \$14.7 million of net repayments on our project construction loans. See “Credit Facility and Other Financing Arrangements” below for a discussion of our outstanding debt at September 30, 2007.

In 2001, our Board of Directors approved an open market share purchase program for up to 0.7 million shares of our common stock. During the first nine months of 2007, we purchased 33,864 shares for \$1.1 million, a \$32.17 per share average. During the fourth quarter of 2007 through November 7, 2007, we purchased 7,585 shares for \$0.2 million, a \$31.40 per share average. A total of 428,361 shares remain available under this program. Our loan agreement with Comerica provides a limit of \$6.5 million for common stock purchases after September 30, 2005 of which \$4.6 million is currently available. The timing of future purchases of our common stock is dependent on many factors including the price of our common shares, our cash flows and financial position, and general economic and market conditions.

### **Credit Facility and Other Financing Arrangements**

At September 30, 2007, we had total debt of \$42.0 million, including \$2.0 million of current debt, compared to total debt of \$28.0 million at December 31, 2006. Our debt outstanding at September 30, 2007 consisted of the following:

- \$2.0 million of borrowings under the \$45.0 million Comerica revolving credit facility which will mature on May 30, 2008.
- \$40.0 million of borrowings outstanding under seven unsecured term loans, including two \$5.0 million loans, two \$8.0 million loans, a \$7.0 million loan and two \$3.5 million loans, all of which will mature in December 2011.

On June 1, 2007, we entered into three separate loan agreements with First American Asset Management (FAAM). Pursuant to the loan agreements, additional borrowings totaled \$15.0 million, \$10.6 million of which was used to pay down the outstanding amounts under our revolving credit facility with Comerica Bank, and the remainder was used for operations, capital expenditures and other development costs, including the Block 21 Project. The loans mature in

December 2011.

The loan agreements contain customary financial covenants and other restrictions. Except in certain events related to a change in control, the loans may not be prepaid prior to December 31, 2007. Beginning on January 1, 2008, the loans may be prepaid subject to certain reinvestment charges as further described in the related promissory notes. The annual interest rate under the loan agreements is 6.915

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percent. Repayments under the loan agreements can be accelerated upon the occurrence of certain customary events of default. Our obligations under the loan agreements are unsecured.

For a further discussion of our debt see Note 4 of our 2006 Form 10-K.

**STOCK-BASED COMPENSATION**

Effective January 1, 2006, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" or (SFAS No. 123R), using the modified prospective transition method. For more information regarding our accounting for stock-based awards see Note 1 of our 2006 Form 10-K.

Compensation cost charged against earnings for stock-based awards is shown below (in thousands). We capitalized less than \$0.1 million of stock-based compensation costs to fixed assets in the third quarter of 2007, \$0.1 million in the third quarter of 2006, \$0.2 million in the 2007 nine-month period and \$0.2 million in the 2006 nine-month period.

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2007	2006	2007	2006
Cost of sales	\$ 101	\$ 71	\$ 393	\$ 266
General and administrative expenses	160	144	627	628
Total stock-based compensation cost	\$ 261	\$ 215	\$ 1,020	\$ 894

**CAUTIONARY STATEMENT**

Management's Discussion and Analysis of Financial Condition and Results of Operation and Disclosures about Market Risks contains forward-looking statements regarding future reimbursements for infrastructure costs, future events related to financing and regulatory matters, the expected results of our business strategy, and other plans and objectives of management for future operations and activities. Important factors that could cause actual results to differ materially from our expectations include economic and business conditions, business opportunities that may be presented to and pursued by us, changes in laws or regulations and other factors, many of which are beyond our control, and other factors that are described in more detail under "Risk Factors" located in our 2006 Form 10-K.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk.**

There have been no significant changes in our market risks since the year ended December 31, 2006. For more information, please read the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2006.

**Item 4. Controls and Procedures.**

(a) **Evaluation of disclosure controls and procedures.** Our chief executive officer and chief financial officer, with the participation of management, have evaluated the effectiveness of our "disclosure controls and procedures" (as defined in Rules 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1934) as of the end of the period covered by this quarterly report on Form 10-Q. Based on their evaluation, they have concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to Stratus (including our consolidated subsidiaries) required to be disclosed in our periodic Securities and Exchange Commission filings.

(b) **Changes in internal controls.** There has been no change in our internal control over financial reporting that occurred during the third quarter that has materially affected, or is reasonably likely to materially affect our internal

control over financial reporting.

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Table of Contents**PART II. – OTHER INFORMATION**Item 1. Legal Proceedings.

We may from time to time be involved in various legal proceedings of a character normally incident to the ordinary course of our business. We believe that potential liability from any of these pending or threatened proceedings will not have a material adverse effect on our financial condition or results of operations. We maintain liability insurance to cover some, but not all, potential liabilities normally incident to the ordinary course of our business as well as other insurance coverage customary in our business, with such coverage limits as management deems prudent.

Item 1A. Risk Factors.

There have been no material changes to our risk factors since the year ended December 31, 2006. For more information, please read Item 1A included in our Form 10-K for the year ended December 31, 2006.

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

The following table sets forth shares of our common stock we repurchased during the three-month period ended September 30, 2007.

Period	Total Shares Purchased	Average Price Paid Per Share	Current Program <sup>a</sup>	
			Shares Purchased	Shares Available for Purchase
July 1 to 31, 2007	-	\$ -	-	465,410
August 1 to 31, 2007	16,008	32.40	16,008	449,402
September 1 to 30, 2007	13,456	31.01	13,456	435,946
Total	29,464	\$ 31.77	29,464	

- a. In February 2001, our Board of Directors approved an open market share purchase program for up to 0.7 million shares of our common stock. The program does not have an expiration date. Our loan agreement with Comerica provides a limit of \$6.5 million for common stock purchases after September 30, 2005. At September 30, 2007, \$4.8 million remained under the Comerica agreement for purchases of common stock.

Item 6. Exhibits.

The exhibits to this report are listed in the Exhibit Index beginning on page E-1 hereof.

Instruments with respect to other long-term debt of Stratus and its consolidated subsidiaries are omitted pursuant to Item 601(b)(4)(iii) of Regulation S-K since the total amount authorized under each such omitted instrument does not exceed 10 percent of the total assets of Stratus and its subsidiaries on a consolidated basis. Stratus hereby agrees to furnish a copy of any such instrument to the Securities and Exchange Commission upon request.

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**SIGNATURE**

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.

STRATUS PROPERTIES INC.

By: /s/ John E. Baker  
John E. Baker  
Senior Vice President and  
Chief Financial Officer  
(authorized signatory and  
Principal Financial Officer)

Date: November 9, 2007

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**STRATUS PROPERTIES INC.  
EXHIBIT INDEX**

Exhibit  
Number

- 3.1 Amended and Restated Certificate of Incorporation of Stratus. Incorporated by reference to Exhibit 3.1 to the Quarterly Report on Form 10-Q of Stratus for the quarter ended March 31, 2004 (Stratus' 2004 First Quarter Form 10-Q).
- 3.2 Certificate of Amendment to the Amended and Restated Certificate of Incorporation of Stratus, dated May 14, 1998. Incorporated by reference to Exhibit 3.2 to Stratus' 2004 First Quarter Form 10-Q.
- 3.3 Certificate of Amendment to the Amended and Restated Certificate of Incorporation of Stratus, dated May 25, 2001. Incorporated by reference to Exhibit 3.2 to the Annual Report on Form 10-K of Stratus for the year ended December 31, 2001 (Stratus' 2001 Form 10-K).
- 3.4 By-laws of Stratus, as amended as of February 11, 1999. Incorporated by reference to Exhibit 3.4 to Stratus' 2004 First Quarter Form 10-Q.
- 4.1 Rights Agreement dated as of May 16, 2002, between Stratus and Mellon Investor Services LLP, as Rights Agent, which includes the Certificates of Designation of Series C Participating Preferred Stock; the Forms of Rights Certificate Assignment, and Election to Purchase; and the Summary of Rights to Purchase Preferred Shares. Incorporated by reference to Exhibit 4.1 to Stratus' Registration Statement on Form 8-A dated May 22, 2002.
- 4.2 Amendment No. 1 to Rights Agreement between Stratus Properties Inc. and Mellon Investor Services LLC, as Rights Agent, dated as of November 7, 2003. Incorporated by reference to Exhibit 4.1 to the Current Report on Form 8-K of Stratus dated November 7, 2003.
- 10.1 Modification and Extension Agreement by and between Stratus Properties Inc., Stratus Properties Operating Co., L.P., Circle C Land, L.P., Austin 290 Properties, Inc., Calera Court, L.P., and Comerica Bank effective July 19, 2006. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K of Stratus dated July 19, 2006.
- 10.2 Loan Agreement by and between Stratus Properties Inc., Stratus Properties Operating Co., L.P., Circle C Land, L.P., Austin 290 Properties, Inc., Calera Court, L.P., and Comerica Bank dated as of September 30, 2005. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K of Stratus dated September 30, 2005.
- 10.3 Revolving Promissory Note by and between Stratus Properties Inc., Stratus Properties Operating Co., L.P., Circle C Land, L.P., Austin 290 Properties, Inc., Calera Court, L.P., and Comerica Bank dated as of September 30, 2005. Incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K of Stratus dated September 30, 2005.
- 10.4 Loan Agreement dated December 28, 2000, by and between Stratus Properties Inc. and Holliday Fenoglio Fowler, L.P., subsequently assigned to an affiliate of First American

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Asset Management. Incorporated by reference to Exhibit 10.20 to the Annual Report on Form 10-K of Stratus for the year ended December 31, 2000.

- 10.5 Loan Agreement dated June 14, 2001, by and between Stratus Properties Inc. and Holliday Fenoglio Fowler, L.P., subsequently assigned to an affiliate of First American Asset Management. Incorporated by reference to Exhibit 10.20 to the Quarterly Report on Form 10-Q of Stratus for the quarter ended September 30, 2001.
- 10.6 Construction Loan Agreement dated June 11, 2001, between 7500 Rialto Boulevard, L.P. and Comerica Bank-Texas. Incorporated by Reference to Exhibit 10.26 to Stratus' 2001 Form 10-K.
- 10.7 Modification Agreement dated January 31, 2003, by and between Lantana Office Properties I, L.P., formerly 7500 Rialto Boulevard, L.P., and Comerica Bank-Texas. Incorporated by reference to Exhibit 10.19 to the Quarterly Report on Form 10-Q of Stratus for the quarter ended March 31, 2003.

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- 10.8 Second Modification Agreement dated as of December 29, 2003, to be effective as of January 31, 2004, by and between Lantana Office Properties I, L.P., a Texas limited partnership (formerly known as 7500 Rialto Boulevard, L.P.), as borrower, and Comerica Bank, as lender. Incorporated by reference to Exhibit 10.20 to the Annual Report on Form 10-K of Stratus for the year ended December 31, 2003 (Stratus' 2003 Form 10-K).
- 10.9 Guaranty Agreement dated June 11, 2001, by Stratus Properties Inc. in favor of Comerica Bank-Texas. Incorporated by Reference to Exhibit 10.27 to Stratus' 2001 Form 10-K.
- 10.10 Loan Agreement dated September 22, 2003, by and between Calera Court, L.P., as borrower, and Comerica Bank, as lender. Incorporated by reference to Exhibit 10.26 to the Quarterly Report on Form 10-Q of Stratus for the quarter ended September 30, 2003.
- 10.11 Development Agreement dated August 15, 2002, between Circle C Land Corp. and City of Austin. Incorporated by reference to Exhibit 10.18 to the Quarterly Report on Form 10-Q of Stratus for the quarter ended September 30, 2002.
- 10.12 First Modification Agreement dated March 27, 2006, by and between Stratus 7000 West Joint Venture, as Old Borrower, and CarrAmerica Lantana, LP, as New Borrower, and Teachers Insurance and Annuity Association of America, as Lender. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K of Stratus dated March 27, 2006.
- 10.13 Agreement of Sale and Purchase dated November 23, 2005, by and between Stratus Properties Operating Co., L.P., as Seller, and Advanced Micro Devices, Inc., as Purchaser. Incorporated by reference to Exhibit 10.12 to the Quarterly Report on Form 10-Q of Stratus for the quarter ended March 31, 2006 (Stratus' 2006 First Quarter Form 10-Q).
- 10.14 First Amendment to Agreement of Sale and Purchase dated April 26, 2006, by and between Stratus Properties Operating Co., L.P., as Seller, and Advanced Micro Devices, Inc., as Purchaser. Incorporated by reference to Exhibit 10.13 to Stratus' 2006 First Quarter Form 10-Q.
- 10.15 Deed of Trust, Assignment of Leases and Rents, Security Agreement and Fixture Filing dated as of June 30, 2006, by and among Escarpment Village, L.P. and Teachers Insurance and Annuity Association of America. Incorporated by reference to Exhibit 10.15 to the Quarterly Report on Form 10-Q of Stratus for the quarter ended June 30, 2006 (Stratus' 2006 Second Quarter Form 10-Q).
- 10.16 Promissory Note dated as of June 30, 2006, by and between Escarpment Village, L.P. and Teachers Insurance and Annuity Association of America. Incorporated by reference to Exhibit 10.16 to Stratus' 2006 Second Quarter Form 10-Q.
- 10.17 Amended and Restated Loan Agreement between Stratus Properties Inc. and American Strategic Income Portfolio Inc.-II dated as of December 12, 2006. Incorporated by reference to Exhibit 10.17 to the Annual Report on Form 10-K of Stratus for the year ended December 31, 2006 (Stratus' 2006 Form 10-K).
- 10.18

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Amended and Restated Loan Agreement between Stratus Properties Inc. and American Select Portfolio Inc. dated as of December 12, 2006. Incorporated by reference to Exhibit 10.18 to Stratus' 2006 Form 10-K.

- 10.19 Loan Agreement between Stratus Properties Inc. and Holliday Fenoglio Fowler, L.P. dated as of December 12, 2006. Incorporated by reference to Exhibit 10.19 to Stratus' 2006 Form 10-K.
- 10.20 Loan Agreement between Stratus Properties Inc. and Holliday Fenoglio Fowler, L.P. dated as of December 12, 2006. Incorporated by reference to Exhibit 10.20 to Stratus' 2006 Form 10-K.
- 10.21 Letter Agreement between Stratus Properties Inc. and Canyon-Johnson Urban Fund II, L.P., dated as of May 4, 2007. Incorporated by reference to Exhibit 10.21 to the Quarterly Report on Form 10-Q of Stratus for the quarter ended June 30, 2007 (Stratus' 2007 Second Quarter Form 10-Q).

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- 10.22 Loan Agreement between Stratus Properties Inc. and Holliday Fenoglio Fowler, L.P. dated as of June 1, 2007, subsequently assigned to American Select Portfolio Inc., an affiliate of First American Asset Management. Incorporated by reference to Exhibit 10.22 to Stratus' 2007 Second Quarter Form 10-Q.
- 10.23 Loan Agreement between Stratus Properties Inc. and Holliday Fenoglio Fowler, L.P. dated as of June 1, 2007, subsequently assigned to American Strategic Income Portfolio Inc., an affiliate of First American Asset Management. Incorporated by reference to Exhibit 10.23 to Stratus' 2007 Second Quarter Form 10-Q.
- 10.24 Loan Agreement between Stratus Properties Inc. and Holliday Fenoglio Fowler, L.P. dated as of June 1, 2007, subsequently assigned to American Strategic Income Portfolio Inc.-III, an affiliate of First American Asset Management. Incorporated by reference to Exhibit 10.24 to Stratus' 2007 Second Quarter Form 10-Q.
- 10.25 Purchase and Sale Agreement dated as of July 9, 2007, between Escarpment Village, L.P. as Seller and Christopher Investment Company, Inc. as Purchaser. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K of Stratus dated October 12, 2007.
- Executive Compensation Plans and Arrangements (Exhibits 10.26 through 10.37)
- 10.26 Stratus' Performance Incentive Awards Program, as amended, effective February 11, 1999. Incorporated by reference to Exhibit 10.24 to Stratus' 2004 First Quarter Form 10-Q.
- 10.27 Stratus Properties Inc. Stock Option Plan, as amended and restated. Incorporated by reference to Exhibit 10.22 to the Quarterly Report on Form 10-Q of Stratus for the quarter ended March 31, 2007 (Stratus' 2007 First Quarter Form 10-Q).
- 10.28 Stratus Properties Inc. 1996 Stock Option Plan for Non-Employee Directors, as amended and restated. Incorporated by reference to Exhibit 10.23 to Stratus' 2007 First Quarter Form 10-Q.
- 10.29 Stratus Properties Inc. 1998 Stock Option Plan, as amended and restated. Incorporated by reference to Exhibit 10.24 to Stratus' 2007 First Quarter Form 10-Q.
- 10.30 Form of Notice of Grant of Nonqualified Stock Options under the 1998 Stock Option Plan. Incorporated by reference to Exhibit 10.24 to the Quarterly Report on Form 10-Q of Stratus for the quarter ended June 30, 2005 (Stratus' 2005 Second Quarter Form 10-Q).
- 10.31 Form of Restricted Stock Unit Agreement under the 1998 Stock Option Plan. Incorporated by reference to Exhibit 10.26 to Stratus' 2007 First Quarter Form 10-Q.
- 10.32 Stratus Properties Inc. 2002 Stock Incentive Plan, as amended and restated. Incorporated by reference to Exhibit 10.27 to Stratus' 2007 First Quarter Form 10-Q.
- 10.33 Form of Notice of Grant of Nonqualified Stock Options under the 2002 Stock Incentive Plan. Incorporated by reference to Exhibit 10.27 to Stratus' 2005 Second Quarter Form

10-Q.

- 10.34 Form of Restricted Stock Unit Agreement under the 2002 Stock Incentive Plan. Incorporated by reference to Exhibit 10.29 to Stratus' 2007 First Quarter Form 10-Q.
- 10.35 Stratus Director Compensation. Incorporated by reference to Exhibit 10.20 to the Annual Report on Form 10-K of Stratus for the year ended December 31, 2005.
- 10.36 Change of Control Agreement between Stratus Properties Inc. and William H. Armstrong III, effective as of January 26, 2007. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K of Stratus dated January 24, 2007.
- 10.37 Change of Control Agreement between Stratus Properties Inc. and John E. Baker, effective as of January 26, 2007. Incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K of Stratus dated January 24, 2007.

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- 15.1 Letter from PricewaterhouseCoopers LLP regarding the unaudited interim financial statements.
- 31.1 Certification of Principal Executive Officer pursuant to Rule 13a-14(a)/15d-14(a).
- 31.2 Certification of Principal Financial Officer pursuant to Rule 13a-14(a)/15d-14(a).
- 32.1 Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350.
- 32.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350.