

Meritage Homes CORP  
Form 10-Q  
October 31, 2012  
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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, 2012

Or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File Number 1-9977

MERITAGE HOMES CORPORATION  
(Exact Name of Registrant as Specified in Its Charter)

Maryland 86-0611231  
(State or Other Jurisdiction of (I.R.S. Employer  
Incorporation or Organization) Identification No.)

17851 North 85th Street, Suite 300  
Scottsdale, Arizona 85255  
(Address of Principal Executive Offices) (Zip Code)  
(480) 515-8100

(Registrant's Telephone Number, Including Area Code)  
(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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. (Check one):

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

Common shares outstanding as of October 30, 2012: 35,590,401

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## PART I — FINANCIAL INFORMATION

## Item 1. Financial Statements

## MERITAGE HOMES CORPORATION AND SUBSIDIARIES

## UNAUDITED CONSOLIDATED BALANCE SHEETS

(in thousands, except share amounts)

	September 30, 2012	December 31, 2011
Assets:		
Cash and cash equivalents	\$305,049	\$173,612
Investments and securities	66,549	147,429
Restricted cash	15,254	12,146
Other receivables	16,681	14,932
Real estate	1,004,825	815,425
Deposits on real estate under option or contract	12,983	15,208
Investments in unconsolidated entities	12,008	11,088
Property and equipment, net	14,112	13,491
Deferred tax asset	7,709	—
Prepaid expenses and other assets	26,032	18,047
Total assets	\$1,481,202	\$1,221,378
Liabilities:		
Accounts payable	\$52,069	\$37,735
Accrued liabilities	96,364	79,464
Home sale deposits	14,027	8,858
Senior, senior subordinated, convertible senior notes and other borrowings	722,675	606,409
Total liabilities	885,135	732,466
Stockholders' Equity:		
Preferred stock, par value \$0.01. Authorized 10,000,000 shares; none issued and outstanding at September 30, 2012 and December 31, 2011	—	—
Common stock, par value \$0.01. Authorized 125,000,000 shares; issued 35,590,401 and 40,377,021 shares at September 30, 2012 and December 31, 2011, respectively	356	404
Additional paid-in capital	387,234	478,839
Retained earnings	208,477	198,442
Treasury stock at cost, none and 7,891,250 shares at September 30, 2012 and December 31, 2011, respectively	—	(188,773 )
Total stockholders' equity	596,067	488,912
Total liabilities and stockholders' equity	\$1,481,202	\$1,221,378
See accompanying notes to unaudited consolidated financial statements		

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MERITAGE HOMES CORPORATION AND SUBSIDIARIES  
 UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS  
 (in thousands, except per share amounts)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Home closing revenue	\$334,880	\$217,534	\$820,242	\$615,154
Land closing revenue	7,763	—	8,846	100
Total closing revenue	342,643	217,534	829,088	615,254
Cost of home closings	(272,309 )	(178,544 )	(670,125 )	(504,943 )
Cost of land closings	(7,493 )	—	(8,164 )	(91 )
Real estate impairments	(417 )	(920 )	(904 )	(2,174 )
Land impairments	—	(127 )	(669 )	(127 )
Total cost of closings and impairments	(280,219 )	(179,591 )	(679,862 )	(507,335 )
Home closing gross profit	62,154	38,070	149,213	108,037
Land closing gross profit/(loss)	270	(127 )	13	(118 )
Total closing gross profit	62,424	37,943	149,226	107,919
Commissions and other sales costs	(25,855 )	(19,708 )	(67,950 )	(53,876 )
General and administrative expenses	(19,209 )	(16,466 )	(50,446 )	(46,582 )
Earnings from unconsolidated entities, net	2,975	1,797	6,626	3,931
Interest expense	(5,009 )	(7,517 )	(18,718 )	(23,036 )
Other (expense)/income, net	(8,340 )	876	(7,712 )	2,872
Loss on extinguishment of debt	—	—	(5,772 )	—
Income/(loss) before income taxes	6,986	(3,075 )	5,254	(8,772 )
(Provision for)/benefit from income taxes	(202 )	(160 )	4,781	(560 )
Net income/(loss)	\$6,784	\$(3,235 )	\$10,035	\$(9,332 )
Income/(loss) per common share:				
Basic	\$0.19	\$(0.10 )	\$0.30	\$(0.29 )
Diluted	\$0.19	\$(0.10 )	\$0.30	\$(0.29 )
Weighted average number of shares:				
Basic	35,216	32,417	33,541	32,358
Diluted	35,761	32,417	34,010	32,358

See accompanying notes to unaudited consolidated financial statements

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MERITAGE HOMES CORPORATION AND SUBSIDIARIES  
 UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (in thousands)

	Nine Months Ended September 30,	
	2012	2011
Cash flows from operating activities:		
Net income/(loss)	\$ 10,035	\$(9,332 )
Adjustments to reconcile net income/(loss) to net cash used in operating activities:		
Depreciation and amortization	5,913	5,267
Real-estate-related impairments	1,573	2,301
Stock-based compensation	6,095	5,215
Loss on early extinguishment of debt	5,772	—
Equity in earnings from unconsolidated entities	(6,626 )	(3,931 )
Deferred tax asset valuation benefit	(7,709 )	—
Distributions of earnings from unconsolidated entities	6,118	4,609
Other operating expenses	403	371
Changes in assets and liabilities:		
Increase in real estate	(190,509 )	(60,785 )
Decrease/(increase) in deposits on real estate under option or contract	2,192	(3,061 )
Increase in receivables and prepaid expenses and other assets	(1,882 )	(1,797 )
Increase in accounts payable and accrued liabilities	31,204	6,794
Increase in home sale deposits	5,169	3,136
Net cash used in operating activities	(132,252 )	(51,213 )
Cash flows from investing activities:		
Investments in unconsolidated entities	(406 )	(427 )
Distributions of capital from unconsolidated entities	24	10
Purchases of property and equipment	(7,139 )	(5,429 )
Proceeds from sales of property and equipment	470	40
Maturities of investments and securities	190,701	324,000
Payments to purchase investments and securities	(109,798 )	(213,896 )
Increase in restricted cash	(3,108 )	(1,765 )
Net cash provided by investing activities	70,744	102,533
Cash flows from financing activities:		
Repayments of senior notes	(315,080 )	—
Proceeds from issuance of senior and senior convertible notes	426,500	—
Debt issuance costs	(9,500 )	—
Proceeds from issuance of common stock, net	87,125	—
Proceeds from stock option exercises	3,900	1,831
Net cash provided by financing activities	192,945	1,831
Net increase in cash and cash equivalents	131,437	53,151
Cash and cash equivalents at beginning of period	173,612	103,953
Cash and cash equivalents at end of period	\$ 305,049	\$ 157,104
See supplemental disclosures of cash flow information at Note 11.		
See accompanying notes to unaudited consolidated financial statements		

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MERITAGE HOMES CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 — ORGANIZATION AND BASIS OF PRESENTATION

Organization. Meritage Homes is a leading designer and builder of single-family detached homes based on the number of home closings. We primarily build in the historically high-growth regions of the western and southern United States and offer a variety of homes that are designed to appeal to a wide range of homebuyers, including first-time, move-up, active adult and luxury. We have operations in three regions: West, Central and East, which are comprised of seven states: Arizona, Texas, California, Nevada, Colorado, Florida and North Carolina. Through our predecessors, we commenced our homebuilding operations in 1985. Meritage Homes Corporation was incorporated in 1988 as a real estate investment trust in the State of Maryland. On December 31, 1996, through a merger, we acquired the homebuilding operations of our predecessor company. Since January 1997, we have focused exclusively on homebuilding and related activities and no longer operate as a real estate investment trust. Meritage Homes Corporation operates as a holding company, has no independent assets or operations, and its homebuilding construction, development and sales activities are conducted through its subsidiaries.

Our homebuilding and marketing activities are conducted under the name of Meritage Homes in each of our markets, although we also operate as Monterey Homes in Arizona and Texas. At September 30, 2012, we were actively selling homes in 153 communities, with base prices ranging from approximately \$106,000 to \$708,000.

Basis of Presentation. The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. These financial statements should be read in conjunction with the consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2011. The consolidated financial statements include the accounts of Meritage Homes Corporation and those of our consolidated subsidiaries, partnerships and other entities in which we have a controlling financial interest, and of variable interest entities (see Note 3) in which we are deemed the primary beneficiary (collectively, “us”, “we”, “our” and “the Company”). Intercompany balances and transactions have been eliminated in consolidation. In the opinion of management, the accompanying financial statements include all adjustments (consisting only of normal recurring entries), necessary for the fair presentation of our results for the interim periods presented. Results for interim periods are not necessarily indicative of results to be expected for the full year.

Cash and Cash Equivalents. Liquid investments with an initial maturity of three months or less are classified as cash equivalents. Amounts in transit from title companies for home closings of approximately \$43.2 million and \$13.1 million are included in cash and cash equivalents at September 30, 2012 and December 31, 2011, respectively. Included in our cash and cash equivalents balance as of September 30, 2012 are \$77.8 million of money market funds that are invested in short term (three months or less) U.S. government securities.

Restricted Cash. Restricted cash consists of amounts held in restricted accounts as collateral for our letter of credit arrangements. The aggregate capacity of these secured letter of credit arrangements was \$40.0 million at September 30, 2012. Our restricted cash accounts invest in money market accounts and U.S. government securities and totaled \$15.3 million and \$12.1 million at September 30, 2012 and December 31, 2011, respectively.

Investments and Securities. Our investments and securities are comprised of both treasury securities and deposits with money center banks that are FDIC-insured and secured by U.S. government treasury-backed investments, and therefore we believe bear a limited risk of loss. All of our investments are classified as held-to-maturity and are recorded at amortized cost as we have both the ability and intent to hold them until their respective maturities. The contractual lives of these investments are greater than three months but not exceeding 18 months. Due to their short duration and low contractual interest rates, the amortized cost of the investments approximates fair value with no unrecognized gains and losses or other-than-temporary impairments.

Real Estate. Real estate is stated at cost unless the asset is determined to be impaired, at which point the inventory is written down to fair value as required by Accounting Standards Codification (“ASC”) Subtopic 360-10, Property, Plant and Equipment (“ASC 360-10”). Inventory includes the costs of land acquisition, land development, home construction, capitalized interest, real estate taxes, capitalized direct overhead costs incurred during development and home

construction that benefit the entire community, less impairments, if any. Land and development costs are typically allocated and transferred to homes under construction when construction begins. Home construction costs are accumulated on a per-home basis, while selling costs are expensed as incurred. Cost of home closings includes the specific construction costs of the home and all related allocated land acquisition, land development and other common costs (both incurred and estimated to be incurred) that are allocated based upon the total number of homes expected to be closed in each community or phase. Any changes to the estimated total

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development costs of a community or phase are allocated to the remaining homes in the community or phase. When a home closes, we may have incurred costs for goods and services that have not yet been paid. Therefore, an accrued liability to capture such obligations is recorded in connection with the home closing and charged directly to cost of sales.

We rely on certain estimates to determine our construction and land development costs. Construction and land costs are comprised of direct and allocated costs, including estimated future costs. In determining these costs, we compile project budgets that are based on a variety of assumptions, including future construction schedules and costs to be incurred. It is possible that actual results could differ from budgeted amounts for various reasons, including construction delays, labor or material shortages, increases in costs that have not yet been committed, changes in governmental requirements, or other unanticipated issues encountered during construction and development and other factors beyond our control. To address uncertainty in these budgets, we assess, update and revise project budgets on a regular basis, utilizing the most current information available to estimate construction and land costs.

Typically, a community's life cycle ranges from three to five years, commencing with the acquisition of the land, continuing through the land development phase, if applicable, and concluding with the sale, construction and closing of the homes. Actual community lives will vary based on the size of the community, the sales absorption rate and whether the land purchased was raw, partially-developed or in finished status. Master-planned communities encompassing several phases and super-block land parcels may have significantly longer lives and projects involving smaller finished lot purchases may be shorter.

All of our land inventory and related real estate assets are reviewed for recoverability quarterly, as our inventory is considered "long-lived" in accordance with GAAP. Impairment charges are recorded to write down an asset to its estimated fair value if the undiscounted cash flows expected to be generated by the asset are lower than its carrying amount. Our determination of fair value is based on projections and estimates. Changes in these expectations may lead to a change in the outcome of our impairment analysis, and actual results may also differ from our assumptions. Our analysis is completed on a quarterly basis with each community or land parcel evaluated individually. For those assets deemed to be impaired, the impairment recognized is measured as the amount by which the assets' carrying amount exceeds their fair value. The impairment of a community is allocated to each lot on a straight-line basis.

Existing and continuing communities. When projections for the remaining income expected to be earned from existing communities are no longer positive, the underlying real estate assets are not deemed fully recoverable, and further analysis is performed to determine the required impairment. The fair value of the community's assets is determined using either a discounted cash flow model for projects we intend to build out or a market-based approach for projects to be sold. Impairments are charged to cost of home closings in the period during which it is determined that the fair value is less than the assets' carrying amount. If a market-based approach is used, we determine fair value based on recent comparable purchase and sale activity in the local market, adjusted for variances as determined by our knowledge of the region and general real estate expertise. If a discounted cash flow approach is used, we compute our fair value based on a proprietary model. Our key estimates in deriving fair value under our cash flow model are (i) home selling prices in the community adjusted for current and expected sales discounts and incentives, (ii) costs related to the community — both land development and home construction — including costs spent to date and budgeted remaining costs to spend, (iii) projected sales absorption rates, reflecting any product mix change strategies implemented to stimulate the orders pace and expected cancellation rates, (iv) alternative land uses including disposition of all or a portion of the land owned and (v) our discount rate, which is currently 14-16% and varies based on the perceived risk inherent in the community's other cash flow assumptions. These assumptions vary widely across different communities and geographies and are largely dependent on local market conditions. Community-level factors that may impact our key estimates include:

- The presence and significance of local competitors, including their offered product type, comparable lot size, and competitive actions;

- Economic and related demographic conditions for the population of the surrounding community;

- Desirability of the particular community, including unique amenities or other favorable or unfavorable attributes; and

- Existing home inventory supplies, including foreclosures and short sales.

These local circumstances may significantly impact our assumptions and the resulting computation of fair value and are, therefore, closely evaluated by our division personnel in their generation of the discounted cash flow models. The models are also evaluated by regional and corporate personnel for consistency and integration, as decisions that affect pricing or absorption at one community may have resulting consequences for neighboring communities. We typically do not project market improvements in our discounted cash flow models, but may do so in limited circumstances in the latter years of a long-lived community.

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Mothball communities. In certain cases, we may elect to stop development of an existing community (mothball) if we believe the economic performance of the community would be maximized by deferring development for a period of time to allow market conditions to improve. The decision may be based on financial and/or operational metrics. If we decide to mothball a community, we will impair it to its fair value as discussed above and then cease future development activity until such a time when management believes that market conditions have improved and economic performance will be maximized. No costs are capitalized to communities that are designated as mothballed. Quarterly, we review all communities, including mothballed communities, for potential impairments.

When a community is initially placed into mothball status, it is management's belief that the community is affected by local market conditions that are expected to improve within the next 1-5 years. Therefore, a temporary postponement of construction and development work is expected to yield better overall returns.

In addition to our quarterly impairment analysis, which is conducted to determine if any current impairments exist, we also conduct a thorough quarterly review of our underperforming and mothballed communities to determine if they are at risk of future impairment. The financial and operational status and expectations of these communities are analyzed as well as any unique attributes that could be viewed as indicators for future impairments. Adjustments are made accordingly and incremental impairments, if any, are recorded at each re-evaluation. Based on the facts and circumstances available as of September 30, 2012, we do not believe that any of our underperforming or mothballed communities will incur material impairments in the future. Changes in market and/or economic conditions could materially impact the conclusions of this analysis, and there can be no assurances that future impairments will not occur.

Inventory assessments on inactive assets. For our mothballed communities as well as our land held for future development, our inventory assessments typically include highly subjective estimates for future performance, including the timing of development, the product to be offered, sales rates and selling prices of the product when the community is anticipated to open for sales, and the projected costs to develop and construct the community. We evaluate various factors to develop our forecasts, including the availability of and demand for homes and finished lots within the marketplace, historical, current and future sales trends, and third-party data, if available. Based on these factors, we reach conclusions for future performance based on our judgment.

Option deposits and pre-acquisition costs. We also evaluate assets associated with future communities for impairments on a quarterly basis. Using similar techniques described in the Existing and continuing communities section above, we determine if the income to be generated by our future communities is acceptable to us. If the projections indicate that a community is still meeting our internal investment guidelines and is generating a profit, those assets are determined to be fully recoverable and no impairments are required. In cases where we decide to abandon a project, we will fully impair all assets related to such project and will expense and accrue any additional costs that we are contractually obligated to incur. In certain circumstances, we may elect to continue with a project because it is expected to generate positive cash flows, even though it may not be generating an accounting profit. In such cases, we will impair our pre-acquisition costs and deposits, as necessary, and record an impairment to bring the carrying value to fair value. Refer to Note 2 of these consolidated financial statements for further information regarding our impairments.

Deposits. Deposits paid related to purchase contracts and land options are recorded and classified as Deposits on real estate under contract or option until the related land is purchased. Deposits are reclassified as a component of real estate inventory at the time the deposit is used to offset the acquisition price of the lots based on the terms of the underlying agreements. To the extent they are non-refundable, deposits are charged to expense if the land acquisition is terminated or no longer considered probable. Since the acquisition contracts typically do not require specific performance, we do not consider such contracts to be contractual obligations to purchase the land and our total exposure under such contracts is limited to the loss of the non-refundable deposits. The review of the likelihood of the acquisition of contracted lots is completed quarterly in conjunction with the real estate impairment analysis noted above and therefore, if impaired, the deposits are recorded at the lower of cost or fair value. Our deposits were \$13.0 million and \$15.2 million as of September 30, 2012 and December 31, 2011, respectively.

Off-Balance Sheet Arrangements —Joint Ventures. Historically, we have participated in land development joint ventures as a means of accessing larger parcels of land and lot positions, expanding our market opportunities, managing our risk profile and leveraging our capital base; however, in recent years, such ventures have not been a significant avenue

for us to access lots. See Note 4 for additional discussion of our investments in unconsolidated entities. In connection with our land development joint ventures, we may also provide certain types of guarantees to associated lenders. These guarantees can be classified into two categories: (i) Repayment Guarantees and (ii) Completion Guarantees, described in more detail below. Additionally, we have classified a guarantee related to our minority ownership in the South Edge joint venture separately, as there is pending litigation with the venture's lender group regarding that guarantee.

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(In thousands)	At September 30, 2012	At December 31, 2011
Repayment guarantees	\$249	\$346
Completion guarantees (1)	—	—
South Edge guarantee (2)	13,243	13,243
Total guarantees	\$13,492	\$13,589

(1) As our completion guarantees are typically backed by funding from a third party, we believe these guarantees do not represent a potential cash obligation for us, as they require only non-financial performance.

(2) As discussed in Note 13, we dispute the enforceability of this guarantee, and ultimate resolution of this matter will be addressed through litigation and/or settlements.

**Repayment Guarantees.** We and/or our land development joint venture partners occasionally provide limited repayment guarantees on a pro rata basis on the debt of land development joint ventures. If such a guarantee were ever to be called or triggered, the maximum exposure to Meritage would generally be only our pro-rata share of the amount of debt outstanding that was in excess of the fair value of the underlying land securing the debt. Our share of these limited pro rata repayment guarantees as of September 30, 2012 and December 31, 2011 is presented in the table above (excluding any potential recoveries from the joint venture's land assets).

**Completion Guarantees.** If there is development work to be completed, we and our joint venture partners are also typically obligated to the project lender(s) to complete construction of the land development improvements if the joint venture does not perform the required development. Provided we and the other joint venture partners are in compliance with these completion obligations, the project lenders are generally obligated to fund these improvements through any financing commitments available under the applicable joint venture development and construction loans. In addition, we and our joint venture partners have from time to time provided unsecured indemnities to joint venture project lenders. These indemnities generally obligate us to reimburse the project lenders only for claims and losses related to matters for which such lenders are held responsible and our exposure under these indemnities is limited to specific matters such as environmental claims. A part of our project acquisition due diligence process is to determine potential environmental risks and generally we or the joint venture entity obtain an independent environmental review. Per the guidance of ASC460-10, Guarantees, we believe these guarantees are either not applicable or not material to our financial results.

**Surety Bonds.** We and our joint venture partners also indemnify third party surety providers with respect to performance bonds issued on behalf of certain of our joint ventures. If a joint venture does not perform its obligations, the surety bond could be called. If these surety bonds are called and the joint venture fails to reimburse the surety, we and our joint venture partners would be obligated to make such payments. These surety indemnity arrangements are generally joint and several obligations with our joint venture partners. Although a majority of the required work may have been performed, these bonds are typically not released until all development specifications under the bond have been met. None of these bonds have been called to date and we believe it is unlikely that any of these bonds will be called or if called, that any such amounts would be material to us. See the table below for detail of our surety bonds. The joint venture obligations, guarantees and indemnities discussed above are generally provided by us or one or more of our subsidiaries. In joint ventures involving other homebuilders or developers, support for these obligations is generally provided by the parent companies of the joint venture partners. In connection with our periodic real estate impairment reviews, we may accrue for any such commitments where we believe our obligation to pay is probable and can be reasonably estimated. In such situations, our accrual represents the portion of the total joint venture obligation related to our relative ownership percentage. In the limited cases where our venture partners, some of whom are homebuilders or developers who may be experiencing financial difficulties as a result of current market conditions, may be unable to fulfill their pro rata share of a joint venture obligation, we may be fully responsible for these commitments if such commitments are joint and several. We continue to monitor these matters and reserve for these obligations if and when they become probable and can be reasonably estimated. Except as noted below and in Note 13 to these unaudited consolidated financial statements, as of September 30, 2012 and December 31, 2011, we did not have any such reserves.

See Note 13 regarding outstanding litigation related to a joint venture project known as "South Edge" or "Inspirada" and the corresponding reserves and charges we have recorded relating thereto.

Off-Balance Sheet Arrangements — Other. From time to time, we may acquire lots from various development entities pursuant to option and purchase agreements. The purchase price generally approximates the market price at the date the contract is executed (with possible future escalators). See Note 3 for further discussion.

We provide letters of credit in support of our obligations relating to the development of our projects and other

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corporate purposes. Surety bonds to guarantee our performance of certain development and construction activities are generally posted in lieu of letters of credit or cash deposits. The amount of these obligations outstanding at any time varies depending on the stage and level of our development activities, as bonds are generally not released until all development activities under the bond are complete. In the event a bond or letter of credit is drawn upon, we would be obligated to reimburse the issuer. We believe it is unlikely that any significant amounts of these bonds or letters of credit will be drawn upon. The table below outlines our surety bond and letter of credit obligations (in thousands):

	September 30, 2012		December 31, 2011	
	Outstanding	Estimated work remaining to complete	Outstanding	Estimated work remaining to complete
Sureties:				
Sureties related to joint ventures	\$1,950	\$ 1,950	\$1,594	\$ 32
Sureties related to owned projects and lots under contract	81,406	49,246	65,921	37,252
Total sureties	\$83,356	\$ 51,196	\$67,515	\$ 37,284
Letters of Credit ("LOCs"):				
LOCs for land development	\$9,749		\$6,451	N/A
LOCs for general corporate operations	4,991		4,960	N/A
Total LOCs	\$14,740		\$11,411	N/A

Accrued Liabilities. Accrued liabilities consist of the following (in thousands):

	At September 30, 2012	At December 31, 2011
Accruals related to real-estate development and construction activities	\$16,204	\$11,048
Payroll and other benefits	17,621	13,535
Accrued taxes	5,652	3,075
Warranty reserves	22,973	23,136
Legal reserves	16,177	10,157
Other accruals	17,737	18,513
Total	\$96,364	\$79,464

Warranty Reserves. We provide home purchasers with limited warranties against certain building defects and have certain obligations related to those post-construction warranties for closed homes. The specific terms and conditions of these limited warranties vary by state, but overall the nature of the warranties include a complete workmanship and materials warranty typically during the first year after the close of the home and a structural warranty that typically extends up to 10 years subsequent to the close of the home. With the assistance of an actuary for the structural-related warranty, we have estimated these reserves based on the number of home closings and historical data and trends for our communities. We also use industry averages with respect to similar product types and geographic areas in markets where our experience is not robust enough to facilitate a meaningful conclusion. We regularly review our warranty reserves and adjust them, as necessary, to reflect changes in trends as information becomes available. A summary of changes in our warranty reserves follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Balance, beginning of period	\$21,243	\$25,929	\$23,136	\$29,265
Additions to reserve from new home deliveries	2,166	1,825	5,771	4,673
Warranty claims	(436	) (2,474	) (5,934	) (8,269
Adjustments to pre-existing reserves	—	795	—	406
Balance, end of period	\$22,973	\$26,075	\$22,973	\$26,075

Warranty reserves are included in accrued liabilities on the accompanying consolidated balance sheets, and additions and adjustments to the reserves are included in cost of home closings within the accompanying consolidated statements of operations. These reserves are intended to cover costs associated with our contractual and statutory warranty

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obligations, which include, among other items, claims involving defective workmanship and materials. We believe that our total reserves, coupled with our contractual relationships and rights with our trades, are sufficient to cover our general warranty obligations. However, as unanticipated changes in legal, weather, environmental or other conditions could have an impact on our actual warranty costs, future costs could differ significantly from our estimates.

**Recently Issued Accounting Pronouncements.** In May 2011, the Financial Accounting Standards Board (“FASB”) issued ASU 2011-04, which amended ASC 820, Fair Value Measurements (“ASC 820”), providing a consistent definition and measurement of fair value, as well as similar disclosure requirements between U.S. GAAP and International Financial Reporting Standards. ASU 2011-04 changes certain fair value measurement principles, clarifies the application of existing fair value measurement and expands the disclosure requirements. ASU 2011-04 became effective for us beginning January 1, 2012. The adoption of ASU 2011-04 did not have any effect on our consolidated financial statements or disclosures.

In June 2011, the FASB issued ASU 2011-05, Presentation of Comprehensive Income (“ASU 2011-05”). ASU 2011-05 requires the presentation of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements. ASU 2011-05 became effective for us beginning January 1, 2012. The adoption of ASU 2011-05 did not have any effect on our consolidated financial statements or disclosures because our net income equals our comprehensive income.

**NOTE 2 — REAL ESTATE AND CAPITALIZED INTEREST**

Real estate consists of the following (in thousands):

	At September 30, 2012	At December 31, 2011
Homes under contract under construction (1)	\$205,616	\$101,445
Unsold homes, completed and under construction (1)	98,354	97,246
Model homes (1)	55,853	49,892
Finished home sites and home sites under development	524,842	441,242
Land held for development (2)	54,981	55,143
Land held for sale	24,619	29,908
Communities in mothball status (3)	40,560	40,549
	\$1,004,825	\$815,425

(1) Includes the allocated land and land development costs associated with each lot for these homes.

Land held for development primarily reflects land and land development costs related to land where development activity is not currently underway but is expected to begin in the future. In these cases, we may have chosen not to currently develop certain land holdings as they typically represent a portion of a large land parcel that we plan to build out over several years.

Represents communities where we have decided to cease operations (mothball) as we have determined that their economic performance would be maximized by deferring development. In the future, some of these communities may be re-opened while others may be sold to third parties. If we deem our carrying value to not be fully recoverable, we adjust our carrying value for these assets to fair value at the time they are placed into mothball (3) status. As of September 30, 2012, we had three mothballed communities with a carrying value of \$11.2 million in our West Region and eight mothballed communities with a carrying value of \$29.4 million in our Central Region.

During the nine months ended September 30, 2012, we did not place any additional communities into mothball status. We do not capitalize interest for such mothballed assets, and all ongoing costs of land ownership (i.e. property taxes, homeowner association dues, etc.) are also expensed as incurred.

As previously noted, in accordance with ASC 360-10, each of our land inventory and related real estate assets is reviewed for recoverability when impairment indicators are present as our inventory is considered “long-lived” in accordance with GAAP. Due to the current economic environment, we evaluate all of our real estate assets for impairment on a quarterly basis. ASC 360-10 requires impairment charges to be recorded if the asset is not deemed fully recoverable and the fair value of such assets is less than their carrying amounts. Our determination of fair value

is based on projections and estimates. We also evaluate alternative product offerings in communities where impairment indicators are present and other strategies for the land exist, such as selling the land or holding the land for sale in the future. Based on these reviews of all our communities, we recorded the following contract termination and real-estate impairment charges during the three and nine months ended September 30, 2012 and 2011 (in thousands):

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Terminated option/purchase contracts and related pre-acquisition costs:				
West	\$—	\$—	\$—	\$—
Central	263	98	346	100
East	—	—	—	—
Total	\$263	\$98	\$346	\$100
Real estate inventory impairments (1):				
West	\$42	\$295	\$284	\$552
Central	54	468	197	1,235
East	58	59	77	287
Total	\$154	\$822	\$558	\$2,074
Impairments of land held for sale:				
West	\$—	\$—	\$669	\$—
Central	—	127	—	127
East	—	—	—	—
Total	\$—	\$127	\$669	\$127
Total impairments:				
West	\$42	\$295	\$953	\$552
Central	317	693	543	1,462
East	58	59	77	287
Total	\$417	\$1,047	\$1,573	\$2,301

(1) Included in the real estate inventory impairments are impairments of individual homes in a community where the underlying community was not also impaired, as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Individual home impairments:				
West	\$42	\$166	\$284	\$423
Central	54	239	197	695
East	58	59	77	287
Total	\$154	\$464	\$558	\$1,405

The table below reflects the number of communities with real estate inventory impairments for the three- and nine-month periods ended September 30, 2011, excluding home-specific impairments (as noted above) and the fair value of these communities as of September 30, 2011 (dollars in thousands). There were no such impairments recorded for the three and nine month periods ended September 30, 2012.

	Three Months Ended September 30, 2011		
	Number of Communities Impaired	Impairment Charges	Fair Value of Communities Impaired (Carrying Value less Impairments)
West	1	\$ 129	2,501
Central	4	229	6,894
East	—	—	N/A
Total	5	\$ 358	\$ 9,395



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	Nine Months Ended September 30, 2011		
	Number of Communities Impaired	Impairment Charges	Fair Value of Communities Impaired (Carrying Value less Impairments)
West	1	\$ 129	2,501
Central	6	540	13,721
East	—	—	N/A
Total	7	\$ 669	\$ 16,222

In the latter part of 2011, we announced our intent to wind-down operations in the Las Vegas, Nevada market. As of September 30, 2012, we had 33 lots remaining to sell and close in our two remaining actively selling Nevada communities. The value of those lots and any associated homes inventory was \$5.9 million as of September 30, 2012. Based on our current orders pace, we expect to complete our construction operations within 12 to 18 months. The remaining \$18.5 million of our Nevada assets relate to properties that we are not currently developing and which we are either actively marketing for sale or which we have mothballed. In the second quarter of 2012, we entered into a sales contract for \$6.5 million that relates to a parcel of land, of which approximately \$3.3 million was received in July 2012, and the remaining payment due to us January 2013. In addition, in the third quarter of 2012, we sold a second parcel of land to a third party for \$1.1 million, all of which was received as of September 30, 2012. Subject to sufficient qualifying assets, we capitalize interest incurred in connection with the development and construction of real estate. Completed homes and land not actively under development do not qualify for interest capitalization. Capitalized interest is allocated to real estate when incurred and charged to cost of closings when the related property is delivered. To the extent our debt exceeds our qualified assets base, we expense a proportionate share of the interest incurred. A summary of our capitalized interest is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Capitalized interest, beginning of period	\$17,836	\$13,205	\$14,810	\$11,679
Interest incurred	11,654	10,848	33,819	32,545
Interest expensed	(5,009)	(7,517)	(18,718)	(23,036)
Interest amortized to cost of home, land closings and impairments	(4,296)	(2,421)	(9,726)	(7,073)
Capitalized interest, end of period (1)	\$20,185	\$14,115	\$20,185	\$14,115

Approximately \$750,000 of the capitalized interest is related to our joint venture investments and is a component (1) of “Investments in unconsolidated entities” on our consolidated balance sheets as of September 30, 2012 and December 31, 2011.

**NOTE 3 — VARIABLE INTEREST ENTITIES AND CONSOLIDATED REAL ESTATE NOT OWNED**

We enter into purchase and option agreements for land or lots as part of our normal course of business. These purchase and option agreements enable us to acquire properties at one or multiple future dates at pre-determined prices. We believe these acquisition structures reduce our financial risk associated with land acquisitions and holdings and allow us to better maximize our liquidity.

Based on the provisions of the relevant accounting guidance, we have concluded that when we enter into purchase or option agreements to acquire land or lots from an entity, a variable interest entity, or “VIE”, may be created. We evaluate all purchase and option agreements for land to determine whether they are a VIE. ASC 810, Consolidations, requires that for each VIE, we assess whether we are the primary beneficiary and, if we are, we consolidate the VIE in our financial statements and reflect such assets and liabilities as “Real estate not owned.” The liabilities related to consolidated VIEs are excluded from our debt covenant calculations.

In order to determine if we are the primary beneficiary, we must first assess whether we have the ability to control the activities of the VIE that most significantly impact its economic performance. Such activities include, but are not limited to,

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the ability to determine the budget and scope of land development work, if any; the ability to control financing decisions for the VIE; the ability to acquire additional land into the VIE or dispose of land in the VIE not under contract with Meritage; and the ability to change or amend the existing option contract with the VIE. If we are not determined to control such activities, we are not considered the primary beneficiary of the VIE. If we do have the ability to control such activities, we will continue our analysis by determining if we are also expected to absorb a potentially significant amount of the VIE's losses or, if no party absorbs the majority of such losses, if we will benefit from a potentially significant amount of the VIE's expected gains.

In substantially all cases, creditors of the entities with which we have option agreements have no recourse against us and the maximum exposure to loss under our option agreements is limited to non-refundable option deposits and any capitalized pre-acquisition costs. If we are the land developer, we are also at risk for costs over budget related to land development on property we have under option. In these cases, we have typically contracted to complete development at a fixed market cost on behalf of the land owner and any budget savings or shortfalls are borne by us. Some of our option deposits may be refundable to us if certain contractual conditions are not performed by the party selling the lots.

The table below presents a summary of our lots under option or contract at September 30, 2012 (dollars in thousands):

	Number of Lots	Purchase Price	Option/Earnest Money Deposits Cash	
Purchase and option contracts recorded on balance sheet as Real estate not owned	—	\$—	\$ —	
Purchase and option contracts not recorded on balance sheet — non-refundable deposits, committed (1)	2,415	122,914	11,748	
Purchase and option contracts not recorded on balance sheet — refundable deposits, committed	227	5,116	185	
Total committed (on and off balance sheet)	2,642	128,030	11,933	
Total purchase and option contracts not recorded on balance sheet refundable deposits, uncommitted (2)	1,439	42,910	1,050	
Total lots under contract or option	\$4,081	\$170,940	\$ 12,983	
Total option contracts not recorded on balance sheet	\$4,081	\$170,940	\$ 12,983	(3)

(1) Deposits are generally non-refundable except if certain contractual conditions fail or certain contractual obligations are not performed by the selling party.

(2) Deposits are refundable at our sole discretion. We have not completed our acquisition evaluation process and we have not internally committed to purchase these lots.

(3) Amount is reflected in our consolidated balance sheet in the line item "Deposits on real estate under option or contract" as of September 30, 2012.

Generally, our options to purchase lots remain effective as long as we purchase a pre-established minimum number of lots periodically, as determined by the terms of the respective agreement. In nearly all of our option contracts, we have the right not to exercise our option to purchase the lots and forfeit our deposit without further consequences.

Accordingly, we do not consider the payment of the lot purchase price to be a firm contractual obligation. The pre-established number of lot purchases is typically structured to approximate our expected rate of home construction starts.

#### NOTE 4 — INVESTMENTS IN UNCONSOLIDATED ENTITIES

In the past, we have entered into land development joint ventures as a means of accessing larger parcels of land and lot positions, expanding our market opportunities, managing our risk profile and leveraging our capital base. Due to the current homebuilding environment, although we view our involvement with land joint ventures to be beneficial, we do not view such involvement as critical to the success of our homebuilding operations. Based on the structure of these joint ventures, they may or may not be consolidated into our results. Our joint venture partners generally are other

homebuilders, land sellers or other real estate investors. We generally do not have a controlling interest in these ventures, which means our joint venture partners could cause the venture to take actions we disagree with, or fail to take actions we believe should be undertaken, including the sale of the underlying property to repay debt or recoup all or part of the partners' investments. As of September 30, 2012, we had two active equity-method land ventures. We also participate in five mortgage and title business joint ventures. The mortgage joint ventures are engaged in mortgage activities and they provide services to both our clients and other homebuyers. Although some of these ventures

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originate mortgage loans, we have limited recourse related to any mortgages originated by these ventures. Our investments in mortgage and title joint ventures as of September 30, 2012 and December 31, 2011 were \$2.0 million and \$1.2 million, respectively.

For land development joint ventures, we, and in some cases our joint venture partners, usually receive an option or other similar arrangement to purchase portions of the land held by the joint venture. Option prices are generally negotiated prices that approximate market value when we enter into the option contract. For these ventures, our share of the joint venture profit relating to lots we purchase from the joint ventures is deferred until homes are delivered by us and title passes to a homebuyer. Therefore, we allocate the portion of such joint venture profit to the land acquired by us as a reduction in the basis of the property.

Summarized condensed financial information related to unconsolidated joint ventures that are accounted for using the equity method was as follows (in thousands):

	At September 30, 2012	At December 31, 2011
Assets:		
Cash	\$3,802	\$4,530
Real estate	45,804	44,764
Other assets	3,622	3,946
Total assets	\$53,228	\$53,240
Liabilities and equity:		
Accounts payable and other liabilities	\$4,529	\$4,534
Notes and mortgages payable	20,658	20,923
Equity of:		
Meritage (1)	9,303	9,351
Other	18,738	18,432
Total liabilities and equity	\$53,228	