

Meritage Homes CORP
Form 10-Q
August 07, 2007

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2007

or

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

Commission File Number 1-9977

MERITAGE HOMES CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

Maryland

(State or Other Jurisdiction
of Incorporation or Organization)

86-0611231

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

17851 North 85th Street, Suite 300

Scottsdale, Arizona
(Address of Principal Executive Offices)

85255

(Zip Code)

(480) 515-8100

(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.

Yes No

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

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer

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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 August 6, 2007: 26,249,296.

MERITAGE HOMES CORPORATION
FORM 10-Q FOR THE QUARTER ENDED JUNE 30, 2007

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

MERITAGE HOMES CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share amounts)

	June 30, 2007 (unaudited)	December 31, 2006
Assets:		
Cash and cash equivalents	\$ 51,678	\$ 56,710
Receivables	73,201	68,725
Real estate	1,619,705	1,530,602
Real estate not owned	29,581	5,269
Deposits on real estate under option or contract	126,095	167,132
Investments in unconsolidated entities	95,880	114,250
Property and equipment, net	39,655	40,712
Deferred tax asset, net	61,422	28,119
Goodwill	102,585	129,659
Intangibles, net	8,049	9,492
Prepaid expenses and other assets	21,744	19,855
Total assets	\$ 2,229,595	\$ 2,170,525
Liabilities:		
Accounts payable	\$ 85,254	\$ 117,443
Accrued liabilities	213,066	266,683
Home sale deposits	35,807	42,022
Liabilities related to real estate not owned	23,201	4,269
Loans payable and other borrowings	274,611	254,640
Senior and senior subordinated notes	628,719	478,636
Total liabilities	1,260,658	1,163,693
Stockholders Equity:		
Common stock, par value \$0.01. Authorized 125,000,000 shares; issued and outstanding 34,140,364 and 34,035,084 shares at June 30, 2007 and December 31, 2006, respectively	341	340
Additional paid-in capital	339,178	332,652
Retained earnings	818,180	862,602
Treasury stock at cost 7,891,068 shares	(188,762)	(188,762)
Total stockholders equity	968,937	1,006,832
Total liabilities and stockholders equity	\$ 2,229,595	\$ 2,170,525

See accompanying notes to condensed consolidated financial statements

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

	Three Months Ended		Six Months Ended	
	June 30, 2007	2006	June 30, 2007	2006
Home closing revenue	\$ 567,748	\$ 902,851	\$ 1,143,863	\$ 1,749,225
Land closing revenue	919	11,809	2,254	12,706
Total closing revenue	568,667	914,660	1,146,117	1,761,931
Cost of home closings	(558,160)	(683,384)	(1,044,124)	(1,315,695)
Cost of land closings	(748)	(10,658)	(1,894)	(11,577)
Total cost of closings	(558,908)	(694,042)	(1,046,018)	(1,327,272)
Home closing gross profit	9,588	219,467	99,739	433,530
Land closing gross profit	171	1,151	360	1,129
Total closing gross profit	9,759	220,618	100,099	434,659
Commissions and other sales costs	(48,067)	(52,849)	(95,405)	(100,876)
General and administrative expenses	(56,366)	(51,344)	(83,029)	(94,066)
Earnings from unconsolidated entities, net	1,800	5,251	4,946	10,839
Interest expense and other income, net	3,670	3,474	6,803	5,385
(Loss) earnings before (benefit) provision for income taxes	(89,204)	125,150	(66,586)	255,941
(Benefit) provision for income taxes	32,628	(48,095)	25,126	(99,150)
Net (loss) earnings	\$ (56,576)	\$ 77,055	\$ (41,460)	\$ 156,791
(Loss) earnings per common share:				
Basic	\$ (2.16)	\$ 2.90	\$ (1.58)	\$ 5.85
Diluted	\$ (2.16)	\$ 2.82	\$ (1.58)	\$ 5.68
Weighted average number of shares:				
Basic	26,232	26,609	26,199	26,792
Diluted	26,232	27,362	26,199	27,619

See accompanying notes to condensed consolidated financial statements

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

	Six Months Ended	
	June 30,	
	2007	2006
Cash flows from operating activities:		
Net (loss) earnings	\$ (41,460)	\$ 156,791
Adjustments to reconcile net (loss) earnings to net cash used in operating activities:		
Depreciation and amortization	9,044	10,177
Real estate related impairments	98,139	7,295
Goodwill-related impairments	27,952	
Increase in deferred taxes	(32,503)	(2,013)
Stock-based compensation	4,222	7,329
Excess income tax benefit from stock-based awards	(346)	(10,121)
Equity in earnings from unconsolidated entities, includes \$1,120 of impairments to joint venture investments in 2007	(4,946)	(10,839)
Distributions of earnings from unconsolidated entities	8,768	7,836
Changes in assets and liabilities:		
Increase in real estate	(151,735)	(163,203)
Increase (decrease) in deposits on real estate under option or contract	21,159	(7,864)
Increase in receivables and prepaid expenses and other assets	(7,540)	(6,933)
Decrease in accounts payable and accrued liabilities	(88,807)	(34,193)
Decrease in home sale deposits	(6,215)	(8,224)
Net cash used in operating activities	(166,508)	(53,962)
Cash flows from investing activities:		
Investments in unconsolidated entities	(19,693)	(17,270)
Distributions of capital from unconsolidated entities	16,210	15,357
Purchases of property and equipment	(8,254)	(16,356)
Proceeds from sales of property and equipment	360	212
Net cash used in investing activities	(11,377)	(18,057)
Cash flows from financing activities:		
Net borrowings under line of credit agreement	25,000	135,000
Proceeds from loans payable and other borrowings		855
Repayments of loan payable and other borrowings	(1,309)	
Proceeds from issuance of senior subordinated notes	150,000	
Senior subordinated notes issuance costs	(3,043)	
Purchase of treasury stock		(101,488)
Payments of senior notes		(1,254)
Excess income tax benefit from stock-based awards	346	10,121
Proceeds from stock option exercises	1,859	10,438
Net cash provided by financing activities	172,853	53,672
Net decrease in cash and cash equivalents	(5,032)	(18,347)
Cash and cash equivalents at beginning of period	56,710	65,812
Cash and cash equivalents at end of period	\$ 51,678	\$ 47,465

See supplemental disclosures of cash flow information at Notes 7 and 11.

See accompanying notes to condensed consolidated financial statements

MERITAGE HOMES CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

FOR THE SIX MONTHS ENDED JUNE 30, 2007 AND 2006

NOTE 1 - ORGANIZATION AND BASIS OF PRESENTATION

Organization. Meritage Homes is a leading designer and builder of single-family attached and detached homes in the growth regions of the western and southern United States based on the number of home closings. We offer first-time, move-up, active adult and luxury homes to our targeted customer base. We have operations in three regions: West, Central and East, which are comprised of 14 metropolitan areas in Arizona, Texas, California, Nevada, Colorado and Florida. Through our successors, we commenced our homebuilding operations in 1985. Meritage Homes Corporation was incorporated in 1988 in the State of Maryland.

Our homebuilding and marketing activities are conducted under the name of Meritage Homes in each of our markets, except for certain communities in Arizona, where we also operate under the name of Monterey Homes, and in Texas, where we also operate in certain communities as Legacy Homes and Monterey Homes. At June 30, 2007, we were actively selling homes in 222 communities, with base prices ranging from approximately \$118,000 to \$1,187,000.

Basis of Presentation. The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States and 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 necessary for the fair presentation of the interim periods presented.

Real Estate. Real estate is stated at cost and includes the costs of land acquisition, land development and home construction, capitalized interest, real estate taxes and direct overhead costs incurred during development and home construction that benefit the entire community. Land and development costs are typically allocated to individual lots on a relative value basis. The costs of these lots are transferred to homes under construction when construction begins. Home construction costs are accumulated on a per-home basis. Cost of home closings includes the specific construction costs of the home and all related land acquisition, land development and other common costs (both incurred and expected to be incurred) based upon the total number of homes expected to be closed in each community. Any changes to the estimated total development costs of a community are allocated on a relative value basis to the remaining homes in the community. When a home is closed, we may have not yet paid all costs incurred to complete it. At the time of close, we record a liability and a charge to cost of sales for the amount we expect will ultimately be paid to complete the home.

In accordance with Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment of Disposal of Long-Lived Assets* (SFAS No. 144), land inventory and related communities under development are reviewed for potential write-downs annually or when impairment indicators are present. SFAS No. 144 requires that in the event the undiscounted cash flows projected for those assets are less than their carrying amounts, an impairment charge is recorded to bring the assets to fair value. Our determination of fair value is based on projections and estimates, including future sales prices, construction costs and absorption rates. Changes in these expectations may lead to a change in the outcome of our impairment analysis. Our analysis is completed at the community level; therefore, changes in local conditions may affect one or several of our communities. For those assets deemed to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount exceeds the fair value of the assets.

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The impairment charges recorded during the three- and six-month period ended June 30, 2007 and June 30, 2006 were as follows (in thousands):

	Three Months Ended		Six Months Ended	
	June 30, 2007	2006	June 30, 2007	2006
Terminated option/purchase contracts				
West	\$ 6,784	\$ 2,364	\$ 12,211	\$ 2,364
Central	2,970	71	4,750	71
East	10,408	400	19,158	400
Total	\$ 20,162	\$ 2,835	\$ 36,119	\$ 2,835
Real estate inventory impairments				
West	\$ 48,522	\$ 3,711	\$ 48,522	\$ 3,711
Central	5,748	749	6,046	749
East	4,430		5,212	
Total	\$ 58,700	\$ 4,460	\$ 59,780	\$ 4,460
Impairments of joint venture investments				
West	\$ 1,120	\$	\$ 1,120	\$
Central				
East				
Total	\$ 1,120	\$	\$ 1,120	\$
Total impairments				
West	\$ 56,426	\$ 6,075	\$ 61,853	\$ 6,075
Central	8,718	820	10,796	820
East	14,838	400	24,370	400
Total	\$ 79,982	\$ 7,295	\$ 97,019	\$ 7,295

The impairment charges were based on our fair value calculations, which are affected by current market conditions, such as the continued downturn of the homebuilding market, assumptions and expectations, all of which are highly subjective and may differ significantly from actual results if market conditions change.

Off-Balance Sheet Arrangements. We often acquire finished building lots from various development entities pursuant to option and purchase agreements. The purchase price typically approximates the market price at the date the contract is executed. We believe this lot acquisition strategy reduces the financial requirements and risks associated with direct land ownership and land development. Under these option and purchase agreements, we are usually required to make deposits in the form of cash or letters of credit, which may be forfeited if we fail to perform under the applicable agreements. As of June 30, 2007, we had entered into option and purchase agreements with an aggregate purchase price of approximately \$1.7 billion and had made deposits of approximately \$132.5 million in the form of cash and approximately \$41.3 million in letters of credit.

We participate in homebuilding and land development joint ventures from time to time 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. Our participation in joint ventures continues to be an important part of our business model. We and/or our joint venture partners may provide limited repayment guarantees on a pro rata basis on debt of certain unconsolidated land acquisition and development joint ventures. At June 30, 2007, our share of these limited pro rata repayment guarantees was \$40.1 million.

In addition, we and/or our joint venture partners may provide guarantees that are only applicable if and when the joint venture directly, or indirectly through agreement with its joint venture partners or other third parties, causes the joint venture to voluntarily file a bankruptcy or similar liquidation or reorganization action or take other actions that are fraudulent or improper (commonly referred to as bad boy guarantees). These types of guarantees typically are on a pro rata basis and are designed to protect the respective secured lender's remedies with respect to its mortgage or other secured lien on the joint venture's underlying property. To date, no such guarantees have been invoked and we believe it is unlikely that such a guarantee would be invoked in the future as it would require us to voluntarily take actions that would generally be

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disadvantageous to the joint venture and to us. At June 30, 2007, we had outstanding guarantees of this type totaling approximately \$74.1 million. We believe that these guarantees, as defined, unless invoked as described above, are not considered guarantees or indebtedness under our revolving credit facility or senior and senior subordinated indentures.

We and our joint venture partners are also typically obligated to the project lenders to complete 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 the terms of these completion agreements, 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 environmental indemnities to joint venture project lenders. In some instances, our exposure under these indemnities is limited. These indemnities generally obligate us to reimburse the project lenders only for claims related to environmental matters for which such lenders are held responsible. As part of our project acquisition due diligence process to determine potential environmental risks, we generally obtain, or the joint venture entity generally obtains, an independent environmental review from outside consultants.

Additionally, we and our joint venture partners sometimes agree to 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 indemnify the surety. These surety indemnity arrangements are generally joint and several obligations with our other joint venture partners. As of June 30, 2007, we had approximately \$45.3 million of surety bonds outstanding subject to these indemnity arrangements. None of these bonds have been called to date and we believe it is unlikely that any of these bonds will be called.

We also obtain letters of credit and performance, maintenance and other bonds in support of our related obligations with respect to the development of our projects. The amount of these obligations outstanding at any time varies depending on the stage and level of our development activities. In the event the letters of credit or bonds are drawn upon, we would be obligated to reimburse the issuer of the letter of credit or bond. At June 30, 2007, we had approximately \$43.0 million in outstanding letters of credit and \$253.2 million in performance bonds for such purposes. We believe it is unlikely that any of these letters of credit or bonds will be drawn upon.

Intangibles, Net. Intangible assets consist primarily of non-compete agreements, tradenames and home plan designs acquired in connection with our September 2005 acquisition of Greater Homes. These intangible assets were valued at the acquisition date utilizing accepted valuation procedures and are being amortized over their estimated useful lives. The cost and accumulated amortization of our intangible assets was \$7.4 million and \$5.2 million, respectively, at June 30, 2007. In the first six months of 2007, amortization expense was \$0.6 million. Amortization expense is expected to be approximately \$0.4 million in the remaining six months of 2007 and \$0.7, \$0.7 and \$0.4 million per year in 2008, 2009 and 2010, respectively. During the second quarter of 2007, we wrote off \$1.1 million of intangible assets related to non-compete agreements acquired in connection with our acquisition of Colonial Homes in February 2005, which represented all remaining intangible assets related to this acquisition.

Additionally, in accordance with AICPA Statement of Position 98-1, Accounting for Costs of Computer Software Developed or Obtained for Internal Use, we have capitalized software costs at June 30, 2007 with a basis of \$5.4 million, which is net of accumulated amortization of \$6.9 million. In the first six months of 2007, amortization expense was approximately \$1.5 million related to the capitalized software costs and is expected to be approximately \$0.7 million for the remaining six months of 2007 and \$1.2, \$1.2, \$1.2, \$0.9 and \$0.2 million in 2008, 2009, 2010, 2011 and 2012, respectively. Additionally, we have \$0.4 million of capitalized software costs that are still in the application stage.

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

	At June 30, 2007	At December 31, 2006
Accruals related to real estate development and construction activities	\$ 103,405	\$ 120,604
Payroll and other benefits	33,822	54,893
Accrued taxes	2,962	9,112
Warranty reserves	30,986	28,437
Other accruals	41,891	53,637
Total	\$ 213,066	\$ 266,683

Warranty Reserves. As is customary in the homebuilding industry, we have obligations related to post-construction warranties and defects related to homes closed. We have established reserves for these obligations based on historical data and trends with respect to similar product types and geographic areas. Warranty reserves are included in accrued liabilities on the accompanying consolidated balance sheets. Additions to warranty reserves are included in cost of sales within the accompanying consolidated statements of earnings. We periodically review the adequacy of our warranty reserves, and believe they are sufficient to cover potential costs for materials and labor related to post-construction warranties and defects. A summary of changes in our warranty reserves follows (in thousands):

	Three Months Ended		Six Months Ended	
	June 30, 2007	2006	June 30, 2007	2006
Balance, beginning of period	\$ 30,319	\$ 26,229	\$ 28,437	\$ 25,168
Additions to reserve	4,350	5,165	10,712	10,393
Warranty claims and expenses	(3,683)	(4,900)	(8,163)	(9,067)
Balance, end of period	\$ 30,986	\$ 26,494	\$ 30,986	\$ 26,494

Recently Issued Accounting Pronouncements. There were no new accounting pronouncements issued during the quarter ended June 30, 2007 that are expected to have a material effect on our operating results or financial position.

FIN 48. We adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109* (FIN 48) on January 1, 2007. FIN 48 clarifies the accounting and reporting for uncertainties in income tax law. This interpretation prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in a company's income tax returns. The cumulative effect of adopting FIN 48 was an increase in tax reserves and a decrease of \$3.0 million to the January 1, 2007 retained earnings balance.

At January 1, 2007, our unrecognized tax benefits were \$19.2 million, which would, if recognized, provide a benefit to us of \$6.5 million and decrease our effective tax rate. We record interest and penalties related to uncertain tax positions in income tax expense. At January 1, 2007, approximately \$1.9 million of the unrecognized tax benefits represents potential interest and penalties on uncertain tax positions. The decrease in unrecognized tax benefits during the first six months of 2007 was \$13.7 million and includes \$1.0 million of interest. There are currently no unrecognized tax benefits that relate to items which would be affected by expiring statutes of limitation within the next 12 months.

We conduct business and are subject to tax in the U.S and several states. With few exceptions, we are no longer subject to U.S. federal, state, or local income tax examinations by tax authorities for years prior to 2002. Our U.S. income tax return for 2003 has been examined by the IRS. The examination was completed in the second quarter of 2007, and there were no material changes to report.

NOTE 2 REAL ESTATE AND CAPITALIZED INTEREST

Real estate consists of the following (in thousands):

	At June 30, 2007	At December 31, 2006
Homes under contract under construction	\$ 586,142	\$ 589,241
Finished home sites and home sites under development	675,416	592,949
Unsold homes, completed and under construction	267,199	271,559
Model homes	53,800	39,131
Model home lease program	23,111	26,831
Land held for development	14,037	10,891
	\$ 1,619,705	\$ 1,530,602

Subject to sufficient qualifying assets, we capitalize development period interest costs incurred in connection with the development and construction of real estate. Capitalized interest is allocated to qualified real estate assets as incurred and charged to cost of home closings when the associated revenue is recognized. Certain information regarding capitalized interest follows (in thousands):

	Three Months Ended		Six Months Ended	
	June 30, 2007	2006	June 30, 2007	2006
Capitalized interest, beginning of period	\$ 38,929	\$ 24,753	\$ 33,016	\$ 23,939
Interest incurred	16,751	12,600	30,636	24,175
Interest expensed	(319)		(319)	
Interest amortized to cost of home closings	(9,847)	(9,518)	(17,819)	(20,279)
Capitalized interest, end of period	\$ 45,514	\$ 27,835	\$ 45,514	\$ 27,835

At June 30, 2007, approximately \$3.9 million of the capitalized interest is related to our joint venture investments and is a component of Investments in unconsolidated entities on our balance sheet.

NOTE 3 - VARIABLE INTEREST ENTITIES AND CONSOLIDATED REAL ESTATE NOT OWNED

FASB Interpretation No. 46 (as revised), *Consolidation of Variable Interest Entities* (FIN 46R) requires the consolidation of entities in which an enterprise absorbs a majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both, as a result of ownership, contractual or other financial interests in the entity. Prior to the issuance of FIN 46R, entities were generally consolidated when an enterprise had a controlling financial interest through ownership of a majority voting interest in the entity.

Based on the provisions of FIN 46R, we have concluded that when we enter into an option or purchase agreement to acquire land or lots and pay a non-refundable deposit, a variable interest entity, or VIE, may be created because we are deemed to have provided subordinated financial support that will absorb some or all of an entity's expected losses if they occur. For each VIE created, we compute expected losses and residual returns based on the probability of future cash flows as outlined in FIN 46R. If we are the primary beneficiary of the VIE, we will consolidate the VIE in our financial statements.

We have applied FIN 46R by developing a methodology to determine whether or not we are the primary beneficiary of the VIE. Part of this methodology requires the use of estimates in assigning probabilities to various future cash flow possibilities relative to changes in the fair value and changes in the development costs associated with the property. Although we believe that our methodology properly identifies our primary beneficiary status with these VIEs, changes in the probability and other estimates could produce different conclusions.

In most cases, creditors of the entities with which we have option agreements have no recourse against us and the maximum exposure to loss in our option agreements is limited to our option deposit and any capitalized pre-acquisition costs. Often, we are at risk for items over budget related to land development on property we have under option. In these cases, we have contracted to complete development at a fixed cost on behalf of the land owner. Some of our option deposits may be refundable if certain contractual conditions are not performed by the party selling the lots to us.

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The table below presents a summary of our lots under option or contract at June 30, 2007 (dollars in thousands):

	Number of Lots	Purchase Price	Option/Earnest Money Deposits Cash	Letters of Credit
Options recorded on balance sheet as real estate not owned (1), (2)	525	\$ 29,581	\$ 6,380	\$
Option contracts not recorded on balance sheet non-refundable deposits (1)	23,427	\$ 1,310,721	\$ 97,587	\$ 40,841
Purchase contracts not recorded on balance sheet non-refundable deposits (1)	5,193	180,075	27,315	484
Purchase contracts not recorded on balance sheet refundable deposits (3)	3,459	129,832	1,193	
Total options not recorded on balance sheet	32,079	1,620,628	126,095	(4) 41,325
Total lots under option or contract	32,604	\$ 1,650,209	\$ 132,475	\$ 41,325

- (1) Deposits are non-refundable except if certain contractual conditions are not performed by the selling party.
- (2) The purpose and nature of these consolidated lot option contracts (VIEs) is to provide the Company the option to purchase these lots in anticipation of building homes on these lots in the future. Specific performance contracts are included in this balance.
- (3) 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.
- (4) Amount is reflected in our balance sheet in the line item deposits on real estate under option or contract as of June 30, 2007.

Generally, our options to purchase lots remain effective so long as we purchase a pre-established minimum number of lots each month or quarter, as determined by the respective agreement. Although the pre-established number is typically structured to approximate our expected rate of home construction starts, during a weakened homebuilding market as we are currently experiencing, we may purchase lots at an absorption level that exceeds our sales and home starts pace.

NOTE 4 - INVESTMENTS IN UNCONSOLIDATED ENTITIES

We participate in homebuilding and land development joint ventures from time to time 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. 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 also enter into mortgage and title business joint ventures. These unconsolidated entities follow accounting principles generally accepted in the United States of America and we generally share in their profits and losses in accordance with our ownership interests.

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 homebuilding and land development joint ventures, our share of the joint venture earnings 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 such joint venture earnings to the land acquired by us as a reduction in the basis of the property.

We and/or our joint venture partners occasionally provide limited repayment guarantees on a pro rata basis on the debt of the land development joint ventures. At June 30, 2007, our share of these limited pro rata repayment guarantees was approximately \$40.1 million.

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In addition, we and/or our joint venture partners occasionally provide guarantees that are only applicable if and when the joint venture directly, or indirectly through agreement with its joint venture partners or other third parties, causes the joint venture to voluntarily file a bankruptcy or similar liquidation or reorganization action or take other actions that are fraudulent or improper (commonly referred to as "bad boy guarantees"). These types of guarantees typically are on a pro rata basis and are designed to protect the respective secured lender's remedies with respect to its mortgage or other secured lien on the joint venture's underlying property. To date, no such guarantees have been invoked and we believe it is unlikely that such a guarantee would be invoked in the future as it would require us to voluntarily take actions that would generally be disadvantageous to the joint venture and to us. At June 30, 2007, we had outstanding guarantees of this type totaling approximately \$74.1 million. We believe these guarantees, as defined, unless invoked as described above, are not considered guarantees or indebtedness under our revolving credit facility or senior and senior subordinated indentures.

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

	At June 30, 2007	At December 31, 2006
Assets:		
Cash	\$ 17,416	\$ 14,392
Real estate	674,445	723,753
Other assets	26,761	25,722
Total assets	\$ 718,622	\$ 763,867
Liabilities and equity:		
Accounts payable and other liabilities	\$ 18,019	\$ 26,639
Notes and mortgages payable	425,391	471,197
Equity of:		
Meritage	81,555	93,792
Others	193,657	172,239
Total liabilities and equity	\$ 718,622	\$ 763,867

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Revenues	\$ 34,874	\$ 18,804	\$ 48,260	\$ 45,932
Costs and expenses	(28,588)	(8,437)	(38,554)	(17,664)
Net earnings of unconsolidated entities	\$ 6,286	\$ 10,367	\$ 9,706	\$ 28,268
Meritage's share of pre-tax earnings (1) (2)	\$ 1,850	\$ 5,251	\$ 5,019	\$ 11,530

(1) The joint venture financial statements above represent the most recent information available to us. As our portion of pre-tax earnings is recorded on the accrual basis and includes both actual earnings reported to us as well as accrued expected earnings for the period noted above not yet provided to us by our joint venture partners, our relative portion of total net earnings of the unconsolidated joint ventures in the table may not be a meaningful number/percentage.

(2) Our share of pre-tax earnings is recorded in Earnings from unconsolidated entities, net on our consolidated statements of earnings. Our share of pre-tax earnings excludes joint venture earnings related to lots we purchased from the joint ventures. Those earnings are deferred until homes are delivered by us and title passes to a homebuyer.

At June 30, 2007 and December 31, 2006, our investments in unconsolidated entities includes \$4.7 million and \$2.8 million, respectively, related to the difference between the amounts at which our investments are carried and the amount of underlying equity in net assets. These amounts are amortized as the assets of the respective joint ventures are sold. We amortized approximately \$119,000 and \$27,000 in the second quarters of 2007 and 2006, respectively. We amortized approximately \$261,000 and \$763,000 in the first six months of 2007 and 2006, respectively.

In addition to joint ventures accounted for under the equity method summarized in the above table, our investments in unconsolidated entities include joint ventures recorded under the cost method. These joint ventures were formed to acquire large parcels of land, to perform off-site

development work and to sell lots to the joint venture members and other

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third parties. At June 30, 2007, and December 31, 2006, our investments in unconsolidated entities recorded under the cost method were \$9.6 and \$17.7 million, respectively.

At June 30, 2007, our total investment in unconsolidated joint ventures of \$95.9 million is primarily comprised of \$17.8 million in our West Region and \$73.9 million in our Central Region. At December 31, 2006, our total investment in unconsolidated joint ventures of \$114.3 million was primarily comprised of \$35.2 million in our West Region and \$74.7 million in our Central Region.

NOTE 5 - LOANS PAYABLE AND OTHER BORROWINGS

Loans payable consists of the following (in thousands):

	June 30, 2007	December 31, 2006
\$850 million unsecured revolving credit facility maturing May 2011 with extension provisions, and interest payable monthly at LIBOR (5.32% at June 30, 2007) plus 1.25% or prime (8.25% at June 30, 2007)	\$ 251,500	\$ 226,500
Model home lease program, with interest in the form of lease payments payable monthly approximating 7.82% at June 30, 2007	23,111	26,831
Other borrowings, acquisition and development financing		1,309
Total loans payable and other borrowings	\$ 274,611	\$ 254,640

On May 18, 2007, we amended our senior unsecured revolving credit facility (the Credit Facility) with Guaranty Bank and various other financial institutions to extend the maturity to May 18, 2011 and make changes to certain covenants and definitions, including (i) changing certain aggregate asset-type limitations within the borrowing base, (ii) increasing the minimum consolidated tangible net worth requirement to \$600 million plus 50% of consolidated net income (as defined) for each full fiscal quarter ending after December 31, 2006, plus an amount equal to 50% of the aggregate increases in consolidated tangible net worth (as defined) after December 31, 2006 by reason of the issuance and sale of equity interests, plus an amount equal to the net worth of any person that becomes a guarantor after December 31, 2006 by reason of merger or acquisition and (iii) changing the covenants relating to restrictions on the total land and unsold units that we may own. The total borrowing capacity of the credit facility remains at \$850 million.

The construction costs and related debt associated with certain model homes that are owned and leased to us by others and that we use to market our communities are required to be included on our balance sheet. We do not legally own these model homes, but we are reimbursed by the owner for our construction costs and we have the right, but not the obligation, to purchase these homes. Although we have no legal obligation to repay any amounts received from the third-party owner, such amounts are recorded as debt and are typically deemed repaid when we simultaneously exercise our option to purchase the model home and sell it to a third-party home buyer. Should we elect not to exercise our rights to purchase these model homes, the model home costs and related debt under the model lease program will be eliminated upon the termination of the lease, which generally has a maturity date of one to three years from the origination of the lease. During the first six months of 2007, \$3.7 million of such leases were exercised or terminated, \$2.3 million of which were exercised or terminated in the second quarter of 2007.

NOTE 6 - SENIOR AND SENIOR SUBORDINATED NOTES

Senior notes consist of the following (in thousands):

	June 30, 2007	December 31, 2006
7.73% senior subordinated notes due 2017	\$ 150,000	\$
6.25% senior notes due 2015. At June 30, 2007 and December 31, 2006, there was approximately \$1.3 and \$1.4 million in unamortized discount, respectively	348,658	348,571
7.0% senior notes due 2014. At both June 30, 2007, and December 31, 2006, there was approximately \$0.1 million in unamortized premium	130,061	130,065
	\$ 628,719	\$ 478,636

Our Credit Facility and indentures for all our senior and senior subordinated notes contain covenants that require maintenance of certain levels of tangible net worth and compliance with certain minimum financial ratios, place limitations on the payment of dividends and redemptions of equity, and limit the incurrence of additional indebtedness, asset dispositions, mergers, certain investments and creations of liens, among other items. As of and for the quarter ended June 30, 2007, we were in compliance with these covenants. After considering our most restrictive bank covenants, we have additional borrowing availability under the Credit Facility of \$515.9 million at June 30, 2007. The Credit Facility and indentures relating to our senior and senior subordinated notes restrict our ability to pay dividends, and at June 30, 2007, our maximum permitted amount available to pay dividends was \$353.2 million.

Obligations to pay principal and interest on the Credit Facility and senior and senior subordinated notes are guaranteed by all of our subsidiaries (collectively, the Guarantor Subsidiaries), each of which is directly or indirectly 100% owned by Meritage Homes Corporation. Such guarantees are full and unconditional, and joint and several. We do not provide separate financial statements of the Guarantor Subsidiaries because Meritage (the parent company) has no independent assets or operations, the guarantees are full and unconditional and joint and several and there are no non-guarantor subsidiaries. There are no significant restrictions on the ability of the Company or any Guarantor Subsidiary to obtain funds from their respective subsidiaries, as applicable, by dividend or loan.

NOTE 7 - GOODWILL

Goodwill represents the excess of the purchase price of our acquisitions over the fair value of the assets acquired. The changes in the carrying amount of goodwill for the six months ended June 30, 2007, follow (in thousands):

	Corporate	West	Central	East	Total
Balance at December 31, 2006	\$ 1,323	\$ 37,277	\$ 53,970	\$ 37,089	\$ 129,659
Goodwill impairment				(26,886)	(26,886)
Non-cash amortization of excess tax basis		(59)	(36)	(93)	(188)
Balance at June 30, 2007	\$ 1,323	\$ 37,218	\$ 53,934	\$ 10,110	\$ 102,585

Under the guidelines contained in SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill is reviewed for impairment annually or more frequently if certain trigger events or conditions exist. During the second quarter of 2007, we determined that economic conditions had deteriorated to a level requiring the recoverability of goodwill to be re-assessed. Therefore, we re-performed a goodwill impairment analysis as of June 30, 2007, which resulted in a write-down of \$26.9 million in our East Region related to goodwill generated by our acquisition of Colonial Homes in February 2005. This write-down reflects the continued difficult homebuilding environments in Ft. Myers/Naples and our anticipation that such conditions will continue for the foreseeable future, resulting in operations that can no longer support the goodwill that was associated with this division.

NOTE 8 EARNINGS (LOSS) PER SHARE

Basic and diluted earnings per common share are presented in conformity with SFAS No. 128, *Earnings Per Share*. The following table presents the calculation of basic and diluted earnings per common share (in thousands, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Basic weighted average number of shares outstanding	26,232	26,609	26,199	26,792
Effect of dilutive securities:				
Stock options and restricted stock (1)		753		827
Diluted weighted average shares outstanding	26,232	27,362	26,199	27,619
Net (loss) earnings	\$ (56,576)	\$ 77,055	\$ (41,460)	\$ 156,791
Basic (loss) earnings per share	\$ (2.16)	\$ 2.90	\$ (1.58)	\$ 5.85
Diluted (loss) earnings per share (1)	\$ (2.16)	\$ 2.82	\$ (1.58)	\$ 5.68

(1) For periods with a net loss, basic weighted average shares outstanding are used for diluted calculations as required by accounting principles generally accepted in the United States.

At June 30, 2007, all 2.4 million outstanding options were anti-dilutive. For the three and six months ended June 30, 2006, 760 and 679 options, respectively, were anti-dilutive.

NOTE 9 - STOCK-BASED COMPENSATION

We have two stock compensation plans (together, the Plans), which were approved by our stockholders and are administered by our Board of Directors. The Plans authorize awards to officers, key employees, non-employee directors and consultants for up to 6,600,000 shares of common stock, of which 473,542 shares remain available for grant at June 30, 2007. We believe that such awards provide a means of performance-based compensation to attract and retain qualified employees and better align the interests of our employees with those of our stockholders. Generally, option awards are granted with an exercise price equal to the market price of Meritage stock at the date of grant, a five-year ratable vesting period and a seven-year contractual term.

The fair values of option awards are estimated using a Black-Scholes option pricing model that uses the assumptions noted in the following table:

	Six Months Ended June 30,			
	2007		2006	
Expected volatility	42.6	%	46-48	%
Expected dividends	0	%	0	%
Expected term (in years)	4.56		4.80-5.85	
Risk-free interest rate	4.90	%	5.04	5.05 %
Weighted average grant date fair value of options granted	\$ 20.51		\$ 25.63	

As of June 30, 2007, we had \$29.5 million of total unrecognized compensation cost related to non-vested stock-based compensation arrangements granted under the Plans that will be recognized on a straight-line basis over the remaining vesting periods, which we expect to be recognized over a weighted-average period of 3.6 years. For the three months

ended June 30, 2007 and 2006, our total stock-based compensation expense was \$1.9 million (\$1.6 million net of tax) and \$4.7 million (\$3.3 million net of tax), respectively. For the six months ended June 30, 2007 and 2006, our total stock-based compensation expense was \$4.2 million (\$3.2 net of tax) and \$7.3 million (\$5.3 net of tax), respectively. We granted 755,667 options and 96,333 shares of restricted stock during the first six months of 2007.

NOTE 10 - INCOME TAXES

Components of the provision for income taxes (benefit) are (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Federal	\$ (28,729)	\$ 41,614	\$ (22,431)	\$ 85,995
State	(3,899)	6,481	(2,695)	13,155
Total	\$ (32,628)	\$ 48,095	\$ (25,126)	\$ 99,150

NOTE 11 - SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

The following presents certain supplemental cash flow information (in thousands):

	Six Months Ended June 30,	
	2007	2006
Cash paid during the period for:		
Interest	\$ 27,066	\$ 22,072
Income taxes	\$ 31,581	\$ 150,515
Non-cash operating activities:		
Real estate not owned	\$ 24,312	\$ (1,464)
FIN 48 adoption unrecognized tax benefits	\$ 2,962	\$
Non-cash investing activities:		
Distributions from unconsolidated entities	\$ 13,531	\$ 4,011

NOTE 12 OPERATING AND REPORTING SEGMENTS

As defined in SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information*, we have six operating segments (the six states in which we operate). The operating segments aggregating into our three reporting segments have been determined to have similar economic characteristics such as: historical and projected future operating results, employment trends, land acquisition and land constraints, municipality behavior, and also meet the other qualitative aggregation criteria. Our reportable homebuilding segments are as follows:

West: California and Nevada

Central: Texas, Arizona and Colorado

East: Florida

Management's evaluation of segment performance is based on segment operating income, which we define as homebuilding and land revenues less cost of home construction, commissions and other sales costs, land development and other land sales costs and other costs incurred by or allocated to each segment. Each reportable segment follows the same accounting policies described in Note 1, *Organization and Basis of Presentation*, to the consolidated financial statements in our 2006 Annual Report on Form 10-K. Operating results for each segment may not be indicative of the results for such segment had it been an independent, stand-alone entity for the periods presented. The following segment information is in thousands:

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	Three Months Ended		Six Months Ended	
	June 30, 2007	2006	June 30, 2007	2006
Revenue (1):				
West	\$ 120,905	\$ 288,691	\$ 238,317	\$ 609,730
Central	404,664	556,483	824,839	1,008,413
East	43,098	69,486	82,961	143,788
Consolidated total	\$ 568,667	\$ 914,660	\$ 1,146,117	\$ 1,761,931
Operating (loss) income (2):				
West	\$ (63,441)	\$ 41,396	\$ (70,993)	\$ 105,519
Central	21,060	90,562	60,631	159,637
East	(17,477)	9,118	(25,568)	18,884
Segment operating (loss) income	(59,858)	141,076	(35,930)	284,040
Corporate and unallocated (3)	(34,816)	(24,651)	(42,405)	(44,323)
Earnings from unconsolidated entities, net	1,800	5,251	4,946	10,839
Interest expense and other income, net	3,670	3,474	6,803	5,385
(Loss) earnings before (benefit) provision for income taxes	\$ (89,204)	\$ 125,150	\$ (66,586)	\$ 255,941

	At June 30, 2007	At December 31, 2006
Assets		
West	\$ 654,865	\$ 602,039
Central	1,215,263	1,183,533
East	144,813	168,010
Corporate and unallocated (4)	214,654	216,943
Consolidated total	\$ 2,229,595	\$ 2,170,525

(1) Revenue includes the following land closing revenue, by segment (in thousands): three months ended June 30, 2007 - \$919 in Central Region; three months ended June 30, 2006 - \$11,474 in West Region and \$335 in Central Region. Six months ended June 30, 2007 - \$2,254 in Central Region; six months ended June 30, 2006 - \$11,474 in West Region and \$1,232 in Central Region.

(2) See Note 1 for a breakout of real estate-related impairments by Region.

(3) Balance consists primarily of corporate costs and numerous shared service functions such as finance, legal and treasury that are not allocated to the operating segments.

(4) Balance consists primarily of goodwill and intangibles and other corporate assets not allocated to the segments.

See additional segment discussions in Notes 4 and 7.

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

Overview

We are a leading designer and builder of single-family attached and detached homes in the growth regions of the western and southern United States based on the number of home closings. We focus on providing a broad range of first-time, move-up, active adult and luxury homes to our targeted customer base. Despite the difficult national market conditions for the homebuilders, we believe that the relatively strong population, job and income growth, as well as the favorable migration characteristics in our markets will continue to provide significant long-term growth opportunities for us. At June 30, 2007, we were actively selling homes in 222 communities, with base prices ranging from \$118,000 to \$1,187,000.

We operate in the following geographic regions, which are presented as our reportable business segments:

West: California and Nevada

Central: Texas, Arizona and Colorado

East: Florida

Total home closing revenue was \$567.7 million for the three months ended June 30, 2007, decreasing 37.1% from \$902.9 million for the same period last year. Net earnings for the second quarter of 2007 decreased \$133.7 million to a loss of (\$56.6) million from earnings of \$77.1 million in the same period last year. This decrease is primarily due to the \$28.0 million (pre-tax) of goodwill-related impairments and \$80.0 million (pre-tax) of real estate-related impairments recorded in the second quarter of 2007 as compared to \$7.3 million of real-estate impairments in the same period of 2006 (there were no goodwill impairments in 2006). The decline was also impacted by the continued weakened homebuilding market experienced in 2007 compared to 2006. For the six months ended June 30, 2007, home closing revenue and net income were \$1.1 billion and a loss of (\$41.5) million, down \$605.4 million and \$198.3 million, respectively, from the same time in the prior year. These declines are due to the lower average home prices from competitive pressures and the increased use of incentives, as well as the sales mix of homes closed and \$125.0 million (pre-tax) of real estate-related and goodwill-related impairments for the first half of 2007. Additionally, our 2007 revenue is the result of closing orders taken during late 2006 and early 2007, a period of weaker sales volumes as well for the homebuilding market.

We began experiencing slowdowns in our northern California markets in the fourth quarter of 2005. The downturn eventually affected the rest of the country in subsequent quarters throughout 2006, resulting in a decline in order dollars and volume. During the first half of 2007, we have also begun to see some slowing in Texas, although not to the extent of other markets. Due to the relatively stable conditions in Texas, it now comprises a larger percentage of our total closings and orders. Based on the homebuilding market downturn and increased presence in Texas, we expect our home closing gross margins to continue to trend lower throughout 2007 and in 2008.

It is also our expectation that sales in our markets that experienced robust sales activity in 2005 and 2006 will continue to decrease, and we expect the home order rate to continue to be soft during the remainder of 2007. At June 30, 2007, our backlog of approximately \$1.2 billion shows a decrease of 38.8% when compared to June 30, 2006, but decreased only 5.2% compared to March 31, 2007. These decreases are due to fewer home sales, compounded by increased price concessions and incentives, as the average sales price in backlog decreased from \$335,000 at June 30, 2006 to \$319,200 at March 31, 2007 to \$312,200 at June 30, 2007. In the second quarter of 2007, our cancellation rate on sales orders increased to 36.6% of gross orders (or 25.2% of beginning backlog) as compared to 31.6% (15.2% of beginning backlog), in the same period a year ago, and also increased from 27.4% (21.2% of beginning of backlog) for the three months ended March 31, 2007. The increased levels of cancellations demonstrate that: buyers are still not confident that their new home purchases will retain their value and are waiting for a sign that the market is stabilizing before buying a new home; that buyers may not be able to sell their existing homes and elect to cancel their new home purchases; and the constriction of the mortgage availability to our homebuyers and to the buyers of their existing homes. We believe our experiences are consistent with the overall trends in the homebuilding industry. During the remainder of 2007 and beyond, based on current market conditions, we expect average closing sales prices to continue to decline, as reflected by the lower average sales price in backlog. Margins will also remain compressed due to price competition resulting from the excess of new and existing home inventories and higher land costs from land contracts negotiated during the homebuilding market peak.

Critical Accounting Policies

The accounting policies we deem most critical to us include revenue recognition, real estate, goodwill, warranty reserves, off-balance-sheet arrangements, valuation of deferred tax assets and share-based payments. There have been no significant changes to our critical accounting policies during the three and six months ended June 30, 2007 compared to those disclosed in Item 7. Management's Discussion and Analysis of

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Financial Condition and Results of Operations, included in our 2006 Annual Report on Form 10-K.

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The data provided below presents operating and financial data regarding our homebuilding activities (dollars in thousands):

Home Closing Revenue

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Total				
Dollars	\$ 567,748	\$ 902,851	\$ 1,143,863	\$ 1,749,225
Homes closed	1,858	2,722	3,654	5,250
Average sales price	\$ 305.6	\$ 331.7	\$ 313.0	\$ 333.2
West Region				
California				
Dollars	\$ 99,256	\$ 208,111	\$ 201,391	\$ 454,994
Homes closed	208	361	402	784
Average sales price	\$ 477.2	\$ 576.5	\$ 501.0	\$ 580.3
Nevada				
Dollars	\$ 21,649	\$ 69,106	\$ 36,926	\$ 143,262
Homes closed	58	172	103	361
Average sales price	\$ 373.3	\$ 401.8	\$ 358.5	\$ 396.8
West Region Totals				