

HOVNANIAN ENTERPRISES INC  
Form 10-Q  
June 06, 2014

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 APRIL 30, 2014

OR

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission file number 1-8551

Hovnanian Enterprises, Inc. (Exact Name of Registrant as Specified in Its Charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)

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22-1851059 (I.R.S. Employer Identification No.)

110 West Front Street, P.O. Box 500, Red Bank, NJ 07701 (Address of Principal Executive Offices)

732-747-7800 (Registrant's Telephone Number, Including Area Code)

N/A (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 check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 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.

Large Accelerated Filer  Accelerated Filer

Non-Accelerated Filer  (Do not check if smaller reporting company) Smaller Reporting Company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. 130,986,187 shares of Class A Common Stock and 14,804,941 shares of Class B Common Stock were outstanding as of June 2, 2014.



HOVNIANIAN ENTERPRISES, INC.

FORM 10-Q

| INDEX  | PAGE<br>NUMBER |
|--|----------------|
| PART I. Financial Information  |                |
| Item 1. Financial Statements:  |                |
| Condensed Consolidated Balance Sheets as of April 30, 2014 (unaudited) and October 31, 2013                            | 3              |
| Condensed Consolidated Statements of Operations (unaudited) for the three and six months ended April 30, 2014 and 2013 | 5              |
| Condensed Consolidated Statement of Equity (unaudited) for the six months ended April 30, 2014                         | 6              |
| Condensed Consolidated Statements of Cash Flows (unaudited) for the six months ended April 30, 2014 and 2013           | 7              |
| Notes to Condensed Consolidated Financial Statements (unaudited)   | 9              |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations                          | 36             |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk   | 59             |
| Item 4. Controls and Procedures  | 60             |
| PART II. Other Information   |                |
| Item 1. Legal Proceedings  | 60             |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds  | 60             |
| Item 6. Exhibits   | 61             |
| Signatures   | 62             |

## HOVNIANIAN ENTERPRISES, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

(In Thousands)

|  | April 30,   | October 31, |
|--|-------------|-------------|
|  | 2014        | 2013        |
|  | (Unaudited) | (1)         |
| <b>ASSETS</b>  |             |             |
| Homebuilding:  |             |             |
| Cash   | \$238,116   | \$319,142   |
| Restricted cash and cash equivalents                         | 11,392      | 10,286      |
| Inventories:   |             |             |
| Sold and unsold homes and lots under development             | 950,978     | 752,749     |
| Land and land options held for future development or sale    | 236,714     | 225,152     |
| Consolidated inventory not owned:                            |             |             |
| Specific performance options                                 | 2,168       | 792         |
| Other options  | 105,796     | 100,071     |
| Total consolidated inventory not owned                       | 107,964     | 100,863     |
| Total inventories  | 1,295,656   | 1,078,764   |
| Investments in and advances to unconsolidated joint ventures | 47,665      | 51,438      |
| Receivables, deposits, and notes – net                       | 52,772      | 45,085      |
| Property, plant, and equipment – net                         | 45,884      | 46,211      |
| Prepaid expenses and other assets                            | 62,656      | 59,351      |
| Total homebuilding   | 1,754,141   | 1,610,277   |
| Financial services:  |             |             |
| Cash   | 7,116       | 10,062      |
| Restricted cash and cash equivalents                         | 17,306      | 21,557      |
| Mortgage loans held for sale at fair value                   | 58,019      | 112,953     |
| Other assets   | 2,241       | 4,281       |
| Total financial services                                     | 84,682      | 148,853     |
| Total assets   | \$1,838,823 | \$1,759,130 |

(1) Derived from the audited balance sheet as of October 31, 2013.

See notes to condensed consolidated financial statements (unaudited).



## HOVNANIAN ENTERPRISES, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

(In Thousands Except Share and Per Share Amounts)

|   | April 30,<br>2014<br>(Unaudited) | October<br>31,<br>2013<br>(1) |
|---|----------------------------------|-------------------------------|
| <b>LIABILITIES AND EQUITY</b>   |                                  |                               |
| Homebuilding:   |                                  |                               |
| Nonrecourse mortgages   | \$92,879                         | \$62,903                      |
| Accounts payable and other liabilities  | 303,332                          | 307,764                       |
| Customers' deposits   | 38,281                           | 30,119                        |
| Nonrecourse mortgages secured by operating properties   | 17,185                           | 17,733                        |
| Liabilities from inventory not owned  | 94,923                           | 87,866                        |
| Total homebuilding  | 546,600                          | 506,385                       |
| Financial services:   |                                  |                               |
| Accounts payable and other liabilities  | 27,018                           | 32,874                        |
| Mortgage warehouse lines of credit  | 35,308                           | 91,663                        |
| Total financial services  | 62,326                           | 124,537                       |
| Notes payable:  |                                  |                               |
| Senior secured notes  | 979,262                          | 978,611                       |
| Senior notes  | 590,113                          | 461,210                       |
| Senior amortizing notes   | 19,004                           | 20,857                        |
| Senior exchangeable notes   | 68,336                           | 66,615                        |
| TEU senior subordinated amortizing notes  | -                                | 2,152                         |
| Accrued interest  | 32,272                           | 28,261                        |
| Total notes payable   | 1,688,987                        | 1,557,706                     |
| Income taxes payable  | 3,423                            | 3,301                         |
| Total liabilities   | 2,301,336                        | 2,191,929                     |
| Equity:   |                                  |                               |
| Hovnanian Enterprises, Inc. stockholders' equity deficit:   |                                  |                               |
| Preferred stock, \$0.01 par value - authorized 100,000 shares; issued and outstanding 5,600 shares with a liquidation preference of \$140,000 at April 30, 2014 and at October 31, 2013   | 135,299                          | 135,299                       |
| Common stock, Class A, \$0.01 par value – authorized 400,000,000 shares; issued 142,746,950 shares at April 30, 2014 and 136,306,223 shares at October 31, 2013 (including 11,760,763 shares at April 30, 2014 and October 31, 2013 held in Treasury) | 1,427                            | 1,363                         |
| Common stock, Class B, \$0.01 par value (convertible to Class A at time of sale) – authorized 60,000,000 shares; issued 15,496,689 shares at April 30, 2014 and 15,347,615  | 155                              | 153                           |

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shares at October 31, 2013 (including 691,748 shares at April 30, 2014 and October 31, 2013 held in Treasury)

|  |              |              |
|--|--------------|--------------|
| Paid in capital – common stock                                 | 692,352      | 689,727      |
| Accumulated deficit  | (1,176,833 ) | (1,144,408 ) |
| Treasury stock – at cost                                       | (115,360 )   | (115,360 )   |
| Total Hovnanian Enterprises, Inc. stockholders’ equity deficit | (462,960 )   | (433,226 )   |
| Noncontrolling interest in consolidated joint ventures         | 447          | 427          |
| Total equity deficit   | (462,513 )   | (432,799 )   |
| Total liabilities and equity                                   | \$1,838,823  | \$1,759,130  |

(1) Derived from the audited balance sheet as of October 31, 2013.

See notes to condensed consolidated financial statements (unaudited).



## HOVNIANIAN ENTERPRISES, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In Thousands Except Per Share Data)

(Unaudited)

|  | Three Months Ended<br>April 30, |           | Six Months Ended<br>April 30, |            |
|--|---------------------------------|-----------|-------------------------------|------------|
|  | 2014                            | 2013      | 2014                          | 2013       |
| Revenues:  |                                 |           |                               |            |
| Homebuilding:  |                                 |           |                               |            |
| Sale of homes  | \$438,302                       | \$409,576 | \$793,483                     | \$743,857  |
| Land sales and other revenues                        | 2,215                           | 2,740     | 2,988                         | 15,011     |
| Total homebuilding                                   | 440,517                         | 412,316   | 796,471                       | 758,868    |
| Financial services                                   | 9,412                           | 10,682    | 17,506                        | 22,341     |
| Total revenues                                       | 449,929                         | 422,998   | 813,977                       | 781,209    |
| Expenses:  |                                 |           |                               |            |
| Homebuilding:  |                                 |           |                               |            |
| Cost of sales, excluding interest                    | 350,433                         | 333,143   | 639,320                       | 621,898    |
| Cost of sales interest                               | 12,407                          | 11,274    | 21,897                        | 21,554     |
| Inventory impairment loss and land option write-offs | 522                             | 2,191     | 1,186                         | 2,856      |
| Total cost of sales                                  | 363,362                         | 346,608   | 662,403                       | 646,308    |
| Selling, general and administrative                  | 47,806                          | 37,802    | 91,768                        | 74,573     |
| Total homebuilding expenses                          | 411,168                         | 384,410   | 754,171                       | 720,881    |
| Financial services                                   | 6,707                           | 7,137     | 13,379                        | 14,565     |
| Corporate general and administrative                 | 14,641                          | 13,725    | 31,033                        | 26,228     |
| Other interest                                       | 23,472                          | 22,632    | 46,805                        | 46,632     |
| Other operations                                     | 1,151                           | (2,814 )  | 2,260                         | (1,914 )   |
| Total expenses                                       | 457,139                         | 425,090   | 847,648                       | 806,392    |
| Loss on extinguishment of debt                       | (1,155 )                        | -         | (1,155 )                      | -          |
| Income from unconsolidated joint ventures            | 1,067                           | 827       | 3,638                         | 3,116      |
| Loss before income taxes                             | (7,298 )                        | (1,265 )  | (31,188 )                     | (22,067 )  |
| State and federal income tax provision (benefit):    |                                 |           |                               |            |
| State  | 604                             | (2,432 )  | 1,237                         | (2,199 )   |
| Federal  | -                               | (151 )    | -                             | (9,878 )   |
| Total income taxes                                   | 604                             | (2,583 )  | 1,237                         | (12,077 )  |
| Net (loss) income                                    | \$(7,902 )                      | \$1,318   | \$(32,425 )                   | \$(9,990 ) |
| Per share data:                                      |                                 |           |                               |            |
| Basic:   |                                 |           |                               |            |
| (Loss) income per common share                       | \$(0.05 )                       | \$0.01    | \$(0.22 )                     | \$(0.07 )  |
| Weighted-average number of common shares outstanding | 146,325                         | 145,948   | 146,151                       | 144,373    |

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Assuming dilution:

|  |          |           |          |            |   |
|--|----------|-----------|----------|------------|---|
| (Loss) income per common share                       | \$ (0.05 | ) \$ 0.01 | \$ (0.22 | ) \$ (0.07 | ) |
| Weighted-average number of common shares outstanding | 146,325  | 147,231   | 146,151  | 144,373    |   |

See notes to condensed consolidated financial statements (unaudited).

## HOVNIANIAN ENTERPRISES, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENT OF EQUITY

(In Thousands Except Share Amounts)

(Unaudited)

|   | A Common Stock                      |         | B Common Stock                      |        | Preferred Stock                     |           | Paid-In<br>Capital | Accumulated<br>Deficit | Treasur<br>Stock |
|---|-------------------------------------|---------|-------------------------------------|--------|-------------------------------------|-----------|--------------------|------------------------|------------------|
|   | Shares<br>Issued and<br>Outstanding | Amount  | Shares<br>Issued and<br>Outstanding | Amount | Shares<br>Issued and<br>Outstanding | Amount    |                    |                        |                  |
| Balance,<br>October 31,<br>2013   | 124,545,460                         | \$1,363 | 14,655,867                          | \$153  | 5,600                               | \$135,299 | \$689,727          | \$(1,144,408 )         | \$(115,3         |
| Stock options,<br>amortization<br>and issuances                               | 17,875                              |         |                                     |        |                                     |           | 2,074              |                        |                  |
| Restricted<br>stock<br>amortization,<br>issuances and<br>forfeitures          | 336,164                             | 4       | 150,538                             | 2      |                                     |           | 611                |                        |                  |
| Settlement of<br>prepaid<br>common stock<br>purchase<br>contracts             | 6,085,224                           | 60      |                                     |        |                                     |           | (60 )              |                        |                  |
| Conversion of<br>Class B to<br>Class A<br>Common<br>Stock                     | 1,464                               |         | (1,464 )                            |        |                                     |           |                    |                        |                  |
| Changes in<br>noncontrolling<br>interest in<br>consolidated<br>joint ventures |                                     |         |                                     |        |                                     |           |                    |                        |                  |

|                         |             |         |            |       |       |           |           |              |            |
|-------------------------|-------------|---------|------------|-------|-------|-----------|-----------|--------------|------------|
| Net loss                |             |         |            |       |       |           |           | (32,425      | )          |
| Balance, April 30, 2014 | 130,986,187 | \$1,427 | 14,804,941 | \$155 | 5,600 | \$135,299 | \$692,352 | \$(1,176,833 | ) \$(115,3 |

See notes to condensed consolidated financial statements (unaudited).

HOVNIANIAN ENTERPRISES, INC. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands)

(Unaudited)

|   | Six Months Ended  |            |
|---|-------------------|------------|
|   | April 30,<br>2014 | 2013       |
| <b>Cash flows from operating activities:</b>                                |                   |            |
| Net loss  | \$(32,425 )       | \$(9,990 ) |
| Adjustments to reconcile net loss to net cash used in operating activities: |                   |            |
| Depreciation  | 1,706             | 2,844      |
| Compensation from stock options and awards                                  | 5,038             | 2,455      |
| Amortization of bond discounts and deferred financing costs                 | 4,913             | 3,646      |
| Gain on sale and retirement of property and assets                          | (216 )            | (4,484 )   |
| Income from unconsolidated joint ventures                                   | (3,638 )          | (3,116 )   |
| Distributions of earnings from unconsolidated joint ventures                | 491               | 738        |
| Loss on extinguishment of debt  | 1,155             | -          |
| Inventory impairment and land option write-offs                             | 1,186             | 2,856      |
| Decrease (increase) in assets:  |                   |            |
| Mortgage notes receivable   | 54,934            | 31,561     |
| Restricted cash, receivables, prepaids, deposits and other assets           | (4,354 )          | 45,486     |
| Inventories   | (218,078 )        | (66,205 )  |
| Increase (decrease) in liabilities:   |                   |            |
| State and federal income tax liabilities                                    | 122               | (8,365 )   |
| Customers' deposits   | 8,162             | 9,147      |
| Accounts payable, accrued interest and other accrued liabilities            | (5,102 )          | (22,493 )  |
| Net cash used in operating activities                                       | (186,106 )        | (15,920 )  |
| <b>Cash flows from investing activities:</b>                                |                   |            |
| Proceeds from sale of property and assets                                   | 232               | 7,147      |
| Purchase of property, equipment, and other fixed assets and acquisitions    | (1,048 )          | (668 )     |
| Decrease in restricted cash related to mortgage company                     | (376 )            | -          |
| Investments in and advances to unconsolidated joint ventures                | (32 )             | (3,012 )   |
| Distributions of capital from unconsolidated joint ventures                 | 6,952             | 14,207     |
| Net cash provided by investing activities                                   | 5,728             | 17,674     |
| <b>Cash flows from financing activities:</b>                                |                   |            |
| Proceeds from mortgages and notes   | 64,301            | 39,216     |
| Payments related to mortgages and notes                                     | (35,401 )         | (38,138 )  |
| Proceeds from model sale leaseback financing programs                       | 30,374            | 3,868      |
| Payments related to model sale leaseback financing programs                 | (10,751 )         | (3,201 )   |
| Proceeds from land bank financing program                                   | 8,666             | 31,294     |
| Payments related to land bank financing program                             | (22,484 )         | (18,602 )  |

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|   |           |           |
|---|-----------|-----------|
| Proceeds from senior notes  | 150,000   | -         |
| Payments related to senior notes  | (22,593 ) | -         |
| Net payments related to mortgage warehouse lines of credit                    | (56,355 ) | (41,497 ) |
| Deferred financing costs from land bank financing programs and note issuances | (5,346 )  | (1,153 )  |
| Principal payments and debt repurchases                                       | (4,005 )  | (1,911 )  |
| Net cash provided by (used in) financing activities                           | 96,406    | (30,124 ) |
| Net decrease in cash and cash equivalents                                     | (83,972 ) | (28,370 ) |
| Cash and cash equivalents balance, beginning of period                        | 329,204   | 273,232   |
| Cash and cash equivalents balance, end of period                              | \$245,232 | \$244,862 |

7

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HOVNANIAN ENTERPRISES, INC. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands - Unaudited)

(Continued)

|   | Six Months<br>Ended |           |
|---|---------------------|-----------|
|   | April 30,<br>2014   | 2013      |
| Supplemental disclosure of cash flow:                   |                     |           |
| Cash paid (received) during the period for income taxes | \$1,104             | \$(3,712) |

Supplemental disclosure of noncash financing activities:

In the first quarter of fiscal 2013, 18,305 of our senior exchangeable notes were exchanged for 3,396,102 shares of Class A Common Stock.

In the first quarter of fiscal 2013, we entered into a new unconsolidated homebuilding joint venture which resulted in the transfer of an existing receivable from our joint venture partners of \$0.6 million at October 31, 2012 to an investment in the joint venture at January 31, 2013.

In the second quarter of fiscal 2013, a property that we previously acquired when our partner in a land development joint venture transferred its interest in the venture to us was foreclosed on by the note holder. As a result, inventory with a book value of \$9.5 million and a corresponding non-recourse liability of an equal amount were taken off our balance sheet in the quarter.

See notes to condensed consolidated financial statements (unaudited).

HOVNIANIAN ENTERPRISES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - UNAUDITED

**1. Basis of Presentation**

Hovnianian Enterprises, Inc. and Subsidiaries (the "Company", "we", "us" or "our") has reportable segments consisting of six Homebuilding segments (Northeast, Mid-Atlantic, Midwest, Southeast, Southwest and West) and the Financial Services segment (see Note 18).

The accompanying unaudited Condensed Consolidated Financial Statements include our accounts and those of all wholly-owned subsidiaries after elimination of all significant intercompany balances and transactions. Certain immaterial prior year amounts have been reclassified to conform to the current year presentation.

The accompanying unaudited Condensed 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 and should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended October 31, 2013. In the opinion of management, all adjustments for interim periods presented have been made, which include normal recurring accruals and deferrals necessary for a fair presentation of our condensed consolidated financial position, results of operations, and cash flows. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates, and these differences could have a significant impact on the financial statements. Results for interim periods are not necessarily indicative of the results which might be expected for a full year. The balance sheet at October 31, 2013 has been derived from the audited Consolidated Financial Statements at that date but does not include all of the information and footnotes required by GAAP for complete financial statements.

**2. Stock Compensation**

For the three and six months ended April 30, 2014, the Company's total stock-based compensation expense was \$1.5 million and \$5.0 million, respectively, and \$1.3 million and \$2.5 million for the three and six months ended April 30, 2013, respectively. Included in this total stock-based compensation expense was the vesting of stock options of \$1.0 million and \$2.0 million for the three and six months ended April 30, 2014, respectively, and \$0.7 million and \$1.5 million for the three and six months ended April 30, 2013, respectively.



**3. Interest**

Interest costs incurred, expensed and capitalized were:

| (In thousands)                              | Three Months Ended |           | Six Months Ended |           |
|---|--------------------|-----------|------------------|-----------|
|   | April 30, 2014     | 2013      | April 30, 2014   | 2013      |
| Interest capitalized at beginning of period | \$107,089          | \$114,429 | \$105,093        | \$116,056 |
| Plus interest incurred (1)                  | 36,782             | 31,965    | 71,601           | 64,618    |
| Less cost of sales interest expensed        | 12,407             | 11,274    | 21,897           | 21,554    |
| Less other interest expensed (2)(3)         | 23,472             | 22,632    | 46,805           | 46,632    |
| Interest capitalized at end of period(4)    | \$107,992          | \$112,488 | \$107,992        | \$112,488 |

(1) Data does not include interest incurred by our mortgage and finance subsidiaries.

Other interest expensed is comprised of interest that does not qualify for interest capitalization because our assets (2) that qualify for interest capitalization (inventory under development) do not exceed our debt. Interest on completed homes and land in planning, which does not qualify for capitalization, is expensed.

Cash paid for interest, net of capitalized interest, is the sum of other interest expensed, as defined above, and (3) interest paid by our mortgage and finance subsidiaries adjusted for the change in accrued interest, which is calculated as follows:

| (In thousands)   | Three Months    |          | Six Months Ended |          |
|--|-----------------|----------|------------------|----------|
|  | Ended April 30, |          | April 30,        |          |
|  | 2014            | 2013     | 2014             | 2013     |
| Other interest expensed                                | \$23,472        | \$22,632 | \$46,805         | \$46,632 |
| Interest paid by our mortgage and finance subsidiaries | 409             | 631      | 1,145            | 1,508    |
| Increase in accrued interest                           | (5,295 )        | (1,600 ) | (4,011 )         | (9,820 ) |
| Cash paid for interest, net of capitalized interest    | \$18,586        | \$21,663 | \$43,939         | \$38,320 |

(4) Capitalized interest amounts are shown gross before allocating any portion of impairments to capitalized interest.

#### 4. Depreciation

Accumulated depreciation at April 30, 2014 and October 31, 2013 amounted to \$75.9 million and \$75.2 million, respectively, for our homebuilding property, plant and equipment.

#### 5. Reduction of Inventory to Fair Value

We record impairment losses on inventories related to communities under development and held for future development when events and circumstances indicate that they may be impaired and the undiscounted cash flows estimated to be generated by those assets are less than their related carrying amounts. If the expected undiscounted cash flows are less than the carrying amount, then the community is written down to its fair value. We estimate the fair value of each impaired community by determining the present value of the estimated future cash flows at a discount rate commensurate with the risk of the respective community. For the six months ended April 30, 2014, no discount rate was used as the one community impaired during the quarter was land held for sale for which a purchase offer price was used to determine the fair value. This land was sold at the offer price in May 2014. For the six months ended April 30, 2013, our discount rate used for the impairments recorded ranged from 18.0% to 18.8%. Should the estimates or expectations used in determining cash flows or fair value decrease or differ from current estimates in the future, we may need to recognize additional impairments.

During the six months ended April 30, 2014, we evaluated inventories of all 508 communities under development and held for future development for impairment indicators through preparation and review of detailed budgets or other market indicators of impairment. We performed detailed impairment calculations for seven of those communities (i.e., those with a projected operating loss or other impairment indicators) with an aggregate carrying value of \$20.5 million. Of those communities tested for impairment, two communities with an aggregate carrying value of \$16.2 million had undiscounted future cash flows that exceeded the carrying amount by less than 20%. As a result of our impairment analysis, we recorded impairment losses of \$0.1 million for both the three and six months ended April 30, 2014, and recorded \$0.9 million and \$1.5 million for the three and six months ended April 30, 2013, respectively, which are included in the Condensed Consolidated Statement of Operations and deducted from inventory.

The following tables represent inventory impairments by homebuilding segment for the three and six months ended April 30, 2014 and 2013:

| (Dollars in millions) | Three Months Ended April 30, 2014 |                                   |                                | Three Months Ended April 30, 2013 |                                   |                                |
|-----------------------|-----------------------------------|-----------------------------------|--------------------------------|-----------------------------------|-----------------------------------|--------------------------------|
|                       | Number of<br>Communities          | Dollar<br>Amount of<br>Impairment | Pre-<br>Impairment<br>Value(1) | Number of<br>Communities          | Dollar<br>Amount of<br>Impairment | Pre-<br>Impairment<br>Value(1) |
| Northeast             | 1                                 | \$0.1                             | \$0.2                          | 1                                 | \$0.9                             | \$2.3                          |
| Mid-Atlantic          | -                                 | -                                 | -                              | -                                 | -                                 | -                              |
| Midwest               | -                                 | -                                 | -                              | -                                 | -                                 | -                              |
| Southeast             | -                                 | -                                 | -                              | -                                 | -                                 | -                              |
| Southwest             | -                                 | -                                 | -                              | -                                 | -                                 | -                              |
| West                  | -                                 | -                                 | -                              | -                                 | -                                 | -                              |
| Total                 | 1                                 | \$0.1                             | \$0.2                          | 1                                 | \$0.9                             | \$2.3                          |

|              | Six Months Ended April 30, 2014 |                             |                         | Six Months Ended April 30, 2013 |                                |                         |
|--------------|---------------------------------|-----------------------------|-------------------------|---------------------------------|--------------------------------|-------------------------|
|              | Number of Communities           | Dollar Amount of Impairment | Pre-Impairment Value(1) | Number of Communities           | Dollar Amount of Impairment(2) | Pre-Impairment Value(1) |
| Northeast    | 1                               | \$0.1                       | \$0.2                   | 2                               | \$1.5                          | \$5.2                   |
| Mid-Atlantic | -                               | -                           | -                       | 1                               | -                              | 0.1                     |
| Midwest      | -                               | -                           | -                       | -                               | -                              | -                       |
| Southeast    | -                               | -                           | -                       | 1                               | -                              | 0.4                     |
| Southwest    | -                               | -                           | -                       | -                               | -                              | -                       |
| West         | -                               | -                           | -                       | -                               | -                              | -                       |
| Total        | 1                               | \$0.1                       | \$0.2                   | 4                               | \$1.5                          | \$5.7                   |

(1) Represents carrying value, net of prior period impairments, if any, at the time of recording the applicable period's impairments.

(2) During the six months ended April 30, 2013, the Mid-Atlantic had an impairment totaling \$2 thousand and the Southeast had an impairment totaling \$17 thousand.

The Condensed Consolidated Statement of Operations line entitled "Homebuilding: Inventory impairment loss and land option write-offs" also includes write-offs of options, and approval, engineering and capitalized interest costs that we record when we redesign communities and/or abandon certain engineering costs and we do not exercise options in various locations because the communities' pro forma profitability is not projected to produce adequate returns on investment commensurate with the risk. Total aggregate write-offs related to these items were \$0.4 million and \$1.3 million for the three months ended April 30, 2014 and 2013, respectively, and \$1.1 million and \$1.4 million for the six months ended April 30, 2014 and 2013, respectively. Occasionally, these write-offs are offset by recovered deposits (sometimes through legal action) that had been written off in a prior period as walk-away costs. Historically, these recoveries have not been significant in comparison to the total cost written off.

The following tables represent write-offs of such costs (after giving effect to any recovered deposits in the applicable period) and the number of lots walked away from by homebuilding segment for the three and six months ended April 30, 2014 and 2013:

| (Dollars in millions) | Three Months Ended April 30, 2014 |                                 | 2013                     |                                |
|-----------------------|-----------------------------------|---------------------------------|--------------------------|--------------------------------|
|                       | Number of Walk-Away Lots          | Dollar Amount of Write-Offs (1) | Number of Walk-Away Lots | Dollar Amount of Write-Offs(1) |
| Northeast             | 40                                | \$0.1                           | 300                      | \$0.1                          |

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|              |     |       |     |       |
|--------------|-----|-------|-----|-------|
| Mid-Atlantic | 88  | -     | 24  | -     |
| Midwest      | 138 | 0.1   | -   | -     |
| Southeast    | 398 | 0.2   | -   | 0.1   |
| Southwest    | 230 | -     | 189 | 1.1   |
| West         | -   | -     | -   | -     |
| Total        | 894 | \$0.4 | 513 | \$1.3 |

| (Dollars in millions) | Six Months Ended April 30, 2014 |                                | 2013                     |                                |
|-----------------------|---------------------------------|--------------------------------|--------------------------|--------------------------------|
|                       | Number of Walk-Away Lots        | Dollar Amount of Write-Offs(1) | Number of Walk-Away Lots | Dollar Amount of Write-Offs(1) |
| Northeast             | 239                             | \$0.5                          | 300                      | \$0.2                          |
| Mid-Atlantic          | 521                             | 0.1                            | 164                      | -                              |
| Midwest               | 403                             | 0.1                            | -                        | -                              |
| Southeast             | 925                             | 0.3                            | -                        | 0.1                            |
| Southwest             | 342                             | 0.1                            | 234                      | 1.1                            |
| West                  | -                               | -                              | -                        | -                              |
| Total                 | 2,430                           | \$1.1                          | 698                      | \$1.4                          |

During the three months ended April 30, 2014, there were write-offs in the Mid-Atlantic totaling \$19 thousand and in the Southwest there were recoveries of \$68 thousand, partially offset by write-offs of \$57 thousand. During (1) the three and six months ended April 30, 2013, there were write-offs in the Mid-Atlantic totaling \$2 thousand and \$8 thousand, respectively.

We decide to mothball (or stop development on) certain communities when we determine that the current performance does not justify further investment at the time. When we decide to mothball a community, the inventory is reclassified from “Sold and unsold homes and lots under development” to “Land and land options held for future development or sale.” During the first half of fiscal 2014, we did not mothball any new communities and sold one community which was previously mothballed. In addition, two communities which were previously mothballed were re-activated during the second quarter of fiscal 2014. As of April 30, 2014, the net book value associated with our 47 total mothballed communities was \$106.2 million, net of impairment charges recorded in prior periods of \$419.2 million.

From time to time we enter into option agreements that include specific performance requirements, whereby we are required to purchase a minimum number of lots. Because of our obligation to purchase these lots, for accounting purposes in accordance with ASC 360-20-40-38, we are required to record this inventory on our Condensed Consolidated Balance Sheets. As of April 30, 2014, we had \$2.2 million of specific performance options recorded on our Condensed Consolidated Balance Sheets to “Consolidated inventory not owned – specific performance options,” with a corresponding liability of \$2.0 million recorded to “Liabilities from inventory not owned.” Consolidated inventory not owned also consists of other options that were included on our balance sheet in accordance with GAAP.

During fiscal 2012, 2013 and 2014, we sold and leased back certain of our model homes with the right to participate in the potential profit when each home is sold to a third party at the end of the respective lease. As a result of our continued involvement, for accounting purposes in accordance with ASC 360-20-40-38, these sale and leaseback transactions are considered a financing rather than a sale. Therefore, for purposes of our Condensed Consolidated Balance Sheet, at April 30, 2014, inventory of \$69.3 million was recorded to “Consolidated inventory not owned – other options,” with a corresponding amount of \$65.3 million recorded to “Liabilities from inventory not owned.”

We have land banking arrangements whereby we sell our land parcels to the land banker and they provide us an option to purchase back finished lots on a quarterly basis. Because of our options to repurchase these parcels, for accounting purposes, in accordance with ASC 360-20-40-38, these transactions are considered a financing rather than a sale. For purposes of our Condensed Consolidated Balance Sheet, at April 30, 2014, inventory of \$36.5 million was recorded as “Consolidated inventory not owned – other options,” with a corresponding amount of \$27.6 million recorded to “Liabilities from inventory not owned” for the amount of net cash received from the transactions.

## **6. Warranty Costs**

General liability insurance for homebuilding companies and their suppliers and subcontractors is very difficult to obtain. The availability of general liability insurance is limited due to a decreased number of insurance companies willing to underwrite for the industry. In addition, those few insurers willing to underwrite liability insurance have significantly increased the premium costs. To date, we have been able to obtain general liability insurance but at higher premium costs with higher deductibles. Our subcontractors and suppliers have advised us that they have also had difficulty obtaining insurance that also provides us coverage. As a result, we have an owner controlled insurance program for certain of our subcontractors, whereby the subcontractors pay us an insurance premium (through a reduction of amounts we would otherwise owe such subcontractors for their work on our homes) based on the risk type of the trade. We absorb the liability associated with their work on our homes as part of our overall general liability insurance at no additional cost to us because our existing general liability and construction defect insurance policy and related reserves for amounts under our deductible covers construction defects regardless of whether we or our subcontractors are responsible for the defect. For the six months ended April 30, 2014 and 2013, we received \$1.0 million in both periods from subcontractors related to the owner controlled insurance program, which we accounted for as a reduction to inventory.

We accrue for warranty costs that are covered under our existing general liability and construction defect policy as part of our general liability insurance deductible. This accrual is expensed as selling, general, and administrative costs. For homes delivered in fiscal 2014 and 2013, our deductible under our general liability insurance is \$20 million per occurrence for construction defect and warranty claims. For bodily injury claims, our deductible per occurrence in fiscal 2014 and 2013 is \$0.25 million, up to a \$5 million limit. Our aggregate retention in fiscal 2014 and 2013 is \$21 million for construction defect, warranty and bodily injury claims. In addition, we establish a warranty accrual for lower cost-related issues to cover home repairs, community amenities, and land development infrastructure that are not covered under our general liability and construction defect policy. We accrue an estimate for these warranty costs as part of cost of sales at the time each home is closed and title and possession have been transferred to the homebuyer. Additions and charges in the warranty reserve and general liability reserve for the three and six months ended April 30, 2014 and 2013 were as follows:

| (In thousands)                                  | Three Months Ended |           | Six Months Ended  |           |
|---|--------------------|-----------|-------------------|-----------|
|   | April 30,<br>2014  | 2013      | April 30,<br>2014 | 2013      |
| Balance, beginning of period                    | \$133,077          | \$121,135 | \$131,028         | \$121,149 |
| Additions – Selling, general and administrative | 4,510              | 4,217     | 9,051             | 8,406     |
| Additions – Cost of sales                       | 2,082              | 3,516     | 4,128             | 6,311     |
| Charges incurred during the period              | (4,804 )           | (3,594 )  | (9,342 )          | (10,592 ) |
| Changes to pre-existing reserves                | -                  | -         | -                 | -         |
| Balance, end of period                          | \$134,865          | \$125,274 | \$134,865         | \$125,274 |

Warranty accruals are based upon historical experience. We engage a third-party actuary that uses our historical warranty and construction defect data, worker's compensation data, and other industry data to assist us in estimating our reserves for unpaid claims, claim adjustment expenses and incurred but not reported claims reserves for the risks that we are assuming under the general liability and workers compensation programs. The estimates include provisions for inflation, claims handling, and legal fees.

Insurance claims paid by our insurance carriers, excluding insurance deductibles paid, were \$1.3 million and \$7.5 million for the three months ended April 30, 2014 and 2013, respectively, and \$4.2 million and \$8.5 million for the six months ended April 30, 2014 and 2013, respectively, for prior year deliveries. For the six months ended April 30, 2014, we settled a construction defect claim relating to the West segment which made up the majority of the payments. For the six months ended April 30, 2013, payments were made up of smaller construction defect claims, primarily in the Northeast.

## 7. Commitments and Contingent Liabilities



We are involved in litigation arising in the ordinary course of business, none of which is expected to have a material adverse effect on our financial position or results of operations, and we are subject to extensive and complex regulations that affect the development and home building, sales and customer financing processes, including zoning, density, building standards and mortgage financing. These regulations often provide broad discretion to the administering governmental authorities. This can delay or increase the cost of development or homebuilding.

We also are subject to a variety of local, state, federal and foreign laws and regulations concerning protection of health and the environment. The particular environmental laws that apply to any given community vary greatly according to the community site, the site's environmental conditions and the present and former uses of the site. These environmental laws may result in delays, may cause us to incur substantial compliance, remediation and/or other costs, and can prohibit or severely restrict development and homebuilding activity.

In March 2013, we received a letter from the EPA requesting information about our involvement in a housing redevelopment project in Newark, New Jersey that a Company entity undertook during the 1990s. We understand that the development is in the vicinity of a former lead smelter and that recent tests on soil samples from properties within the development conducted by the EPA show elevated levels of lead. We also understand that the smelter ceased operations many years before the Company entity involved acquired the properties in the area and carried out the re-development project. We responded to the EPA's request. In August 2013, we were notified that the EPA considers us a potentially responsible party (or "PRP") with respect to the site, that the EPA will clean up the site, and that the EPA is proposing that we fund and/or contribute towards the cleanup of the contamination at the site. We have begun preliminary discussions with the EPA concerning a possible resolution but do not know the scope or extent of the Company's obligations, if any, that may arise from the site and therefore cannot provide any assurance that this matter will not have a material impact on the Company. The EPA requested additional information in April 2014 and the Company has responded to its information request.

We anticipate that increasingly stringent requirements will be imposed on developers and homebuilders in the future. Although we cannot predict the effect of these requirements, they could result in time-consuming and expensive compliance programs and in substantial expenditures, which could cause delays and increase our cost of operations. In addition, our ability to obtain or renew permits or approvals and the continued effectiveness of permits already granted or approvals already obtained is dependent upon many factors, some of which are beyond our control, such as changes in policies, rules, and regulations and their interpretations and application.

The Company is also involved in the following litigation:

Hovnanian Enterprises, Inc. and K. Hovnanian Venture I, L.L.C. (collectively, the “Company Defendants”) have been named as defendants in a class action suit. The action was filed by Mike D’Andrea and Tracy D’Andrea, on behalf of themselves and all others similarly situated in the Superior Court of New Jersey, Gloucester County. The action was initially filed on May 8, 2006 alleging that the HVAC systems installed in certain of the Company’s homes are in violation of applicable New Jersey building codes and are a potential safety issue. On December 14, 2011, the Superior Court granted class certification; the potential class is 1,065 homes. The Company Defendants filed a request to take an interlocutory appeal regarding the class certification decision. The Appellate Division denied the request, and the Company Defendants filed a request for interlocutory review by the New Jersey Supreme Court, which remanded the case back to the Appellate Division for a review on the merits of the appeal on May 8, 2012. The Appellate Division, on remand, heard oral arguments on December 4, 2012, reviewing the Superior Court’s original finding of class certification. On June 18, 2013, the Appellate Division affirmed class certification. On July 3, 2013, the Company Defendants appealed the June 2013 Appellate Division’s decision to the New Jersey Supreme Court, which elected not to hear the appeal on October 22, 2013. The plaintiff class was seeking unspecified damages as well as treble damages pursuant to the NJ Consumer Fraud Act. The Company Defendants’ motion to consolidate an indemnity action they filed against various manufacturer and sub-contractor defendants to require these parties to participate directly in the class action was denied by the Superior Court; however, the Company Defendants’ separate action seeking indemnification against the various manufacturers and subcontractors implicated by the class action is ongoing. The Company Defendants, the Company Defendants’ insurance carriers and the plaintiff class agreed to the terms of a settlement on May 15, 2014 in which the plaintiff class will receive a payment of \$21 million in settlement of all claims, with the majority of the settlement being funded by the Company Defendants’ insurance carriers, which settlement is subject to Court approval.

## **8. Restricted Cash and Deposits**

Cash represents cash deposited in checking accounts. Cash equivalents include certificates of deposit, Treasury bills and government money–market funds with maturities of 90 days or less when purchased. Our cash balances are held at a few financial institutions and may, at times, exceed insurable amounts. We believe we help to mitigate this risk by depositing our cash in major financial institutions. At both April 30, 2014 and October 31, 2013, we had no cash equivalents in “Homebuilding: Cash” or “Financial services: Cash” as the full balance of cash and cash equivalents was held as cash. However, “Homebuilding: Restricted cash and cash equivalents” and “Financial services: Restricted cash and cash equivalents” both included cash equivalents at April 30, 2014 and October 31, 2013.

Restricted cash and cash equivalents on the Condensed Consolidated Balance Sheets, totaled to \$28.7 million and \$31.9 million as of April 30, 2014 and October 31, 2013, respectively, which includes cash collateralizing our letter of credit agreements and facilities and is discussed in Note 10. Also included in this balance are homebuilding and financial services customers' deposits of \$6.2 million and \$17.3 million at April 30, 2014, respectively, and \$5.1 million and \$21.6 million as of October 31, 2013, respectively, which are restricted from use by us.

Total Homebuilding Customers' deposits are shown as a liability on the Condensed Consolidated Balance Sheets. These liabilities are significantly more than the applicable periods' escrow cash balances because, in some states, the deposits are not restricted from use and, in other states, we are able to release the majority of this escrow cash by pledging letters of credit and surety bonds.

### **9. Mortgage Loans Held for Sale**

Our mortgage banking subsidiary originates mortgage loans, primarily from the sale of our homes. Such mortgage loans are sold in the secondary mortgage market within a short period of time of origination. Mortgage loans held for sale consist primarily of single-family residential loans collateralized by the underlying property. We have elected the fair value option to record loans held for sale and therefore these loans are recorded at fair value with the changes in the value recognized in the Condensed Consolidated Statements of Operations in "Revenues: Financial services." We currently use forward sales of mortgage-backed securities, interest rate commitments from borrowers and mandatory and/or best efforts forward commitments to sell loans to investors to protect us from interest rate fluctuations. These short-term instruments, which do not require any payments to be made to the counterparty or investor in connection with the execution of the commitments, are recorded at fair value. Gains and losses on changes in the fair value are recognized in the Condensed Consolidated Statements of Operations in "Revenues: Financial services."

At April 30, 2014 and October 31, 2013, respectively, \$35.6 million and \$94.1 million of mortgages held for sale were pledged against our mortgage warehouse lines of credit (see Note 10). We may incur losses with respect to mortgages that were previously sold that are delinquent and which had underwriting defects, but only to the extent the losses are not covered by mortgage insurance or resale value of the home. The reserves for these estimated losses are included in the “Financial services – Accounts payable and other liabilities” balances on the Condensed Consolidated Balance Sheet. We received 10 and 16 repurchase or make-whole inquiries during the three and six months ended April 30, 2014, respectively. We received 11 and 24 repurchase or make-whole inquiries during the three and six months ended April 30, 2013, respectively.

The activity in our loan origination reserves during the three and six months ended April 30, 2014 and 2013 was as follows:

| (In thousands)  | Three Months Ended |         | Six Months Ended |         |
|---|--------------------|---------|------------------|---------|
|   | April 30, 2014     | 2013    | April 30, 2014   | 2013    |
| Loan origination reserves, beginning of period                              | \$10,719           | \$9,118 | \$11,036         | \$9,334 |
| Provisions for losses during the period                                     | 466                | 709     | 867              | 1,335   |
| Adjustments to pre-existing provisions for losses from changes in estimates | (63 )              | (61 )   | (622 )           | (253 )  |
| Payments/settlements  | (65 )              | -       | (224 )           | (650 )  |
| Loan origination reserves, end of period                                    | \$11,057           | \$9,766 | \$11,057         | \$9,766 |

## 10. Mortgage and Notes Payable

We have nonrecourse mortgages for a small number of our communities totaling \$92.9 million at April 30, 2014, which are secured by the related real property and any improvements. The weighted-average interest rate on these obligations was 5.6% at April 30, 2014, and the mortgage payments on each community primarily correspond to home deliveries. We also have nonrecourse mortgages on our corporate headquarters totaling \$17.2 million at April 30, 2014. These loans had a weighted-average interest rate of 7.0% as of April 30, 2014, and installment obligations with annual principal maturities in the years ending October 31 of approximately: \$0.5 million in 2014, \$1.2 million in 2015, \$1.3 million in 2016, \$1.4 million in 2017, \$1.5 million in 2018 and \$11.3 million after 2018.

In June 2013, K. Hovnanian Enterprises, Inc. (“K. Hovnanian”), as borrower, and we and certain of our subsidiaries, as guarantors, entered into a five-year \$75.0 million unsecured revolving credit facility (the “Credit Facility”) with Citicorp USA, Inc., as administrative agent and issuing bank, and Citibank, N.A., as a lender. The Credit Facility is available for both letters of credit and general corporate purposes. The Credit Facility does not contain any financial maintenance covenants, but does contain certain restrictive covenants that track those contained in our indenture governing the 7.0% Senior Notes due 2019, which are described in Note 11. The Credit Facility also contains certain

customary events of default which would permit the administrative agent at the request of the required lenders to, among other things, declare all loans then outstanding to be immediately due and payable if such default is not cured within applicable grace periods, including the failure to make timely payments of amounts payable under the Credit Facility or other material indebtedness or the acceleration of other material indebtedness, the failure to comply with agreements and covenants or for representations or warranties to be correct in all material respects when made, specified events of bankruptcy and insolvency, and the entry of a material judgment against a loan party. Outstanding borrowings under the Credit Facility accrue interest at an annual rate equal to either, as selected by K. Hovnanian, (i) the alternate base rate plus the applicable spread determined on the date of such borrowing or (ii) an adjusted LIBOR rate plus the applicable spread determined as of the date two business days prior to the first day of the interest period for such borrowing. As of April 30, 2014, there were no borrowings and \$20.0 million of letters of credit outstanding under the Credit Facility and as of such date, we believe we were in compliance with the covenants under the Credit Facility.

In addition to the Credit Facility, we have certain stand-alone cash collateralized letter of credit agreements and facilities under which there were a total of \$5.1 million of letters of credit outstanding at both April 30, 2014 and October 31, 2013. These agreements and facilities require us to maintain specified amounts of cash as collateral in segregated accounts to support the letters of credit issued thereunder, which will affect the amount of cash we have available for other uses. As of both April 30, 2014 and October 31, 2013, the amount of cash collateral in these segregated accounts was \$5.2 million, which is reflected in "Restricted cash and cash equivalents" on the Condensed Consolidated Balance Sheets.

Our wholly owned mortgage banking subsidiary, K. Hovnanian American Mortgage, LLC (“K. Hovnanian Mortgage”), originates mortgage loans primarily from the sale of our homes. Such mortgage loans and related servicing rights are sold in the secondary mortgage market within a short period of time. In certain instances, we retain the servicing rights for a small amount of loans. Our secured Master Repurchase Agreement with JPMorgan Chase Bank, N.A. (“Chase Master Repurchase Agreement”), which was amended on January 31, 2014 to extend the maturity date to January 30, 2015, is a short-term borrowing facility that provides up to \$50.0 million through maturity. The loan is secured by the mortgages held for sale and is repaid when we sell the underlying mortgage loans to permanent investors. Interest is payable monthly on outstanding advances at an adjusted LIBOR rate, which was 0.1505% at April 30, 2014, subject to a floor of 0.375%, plus the applicable margin of 2.875%. Therefore, at April 30, 2014, the interest rate was 3.25%. As of April 30, 2014 and October 31, 2013, the aggregate principal amount of all borrowings outstanding under the Chase Master Repurchase Agreement was \$11.4 million and \$33.6 million, respectively.

K. Hovnanian Mortgage has another secured Master Repurchase Agreement with Customers Bank (“Customers Master Repurchase Agreement”), which was amended on May 27, 2014 to extend the maturity date to May 26, 2015, that is a short-term borrowing facility that provides up to \$37.5 million through maturity. The loan is secured by the mortgages held for sale and is repaid when we sell the underlying mortgage loans to permanent investors. Interest is payable daily or as loans are sold to permanent investors on outstanding advances at the current LIBOR subject to a floor of 0.5% plus the applicable margin ranging from 2.75% to 5.25% based on the takeout investor, type of loan, and the number of days on the warehouse line. As of April 30, 2014 and October 31, 2013, the aggregate principal amount of all borrowings outstanding under the Customers Master Repurchase Agreement was \$9.5 million and \$30.7 million, respectively.

K. Hovnanian Mortgage has a third secured Master Repurchase Agreement with Credit Suisse First Boston Mortgage Capital LLC (“Credit Suisse Master Repurchase Agreement”), which was amended on March 28, 2014, that is a short-term borrowing facility that provides up to \$50.0 million through March 31, 2015. The loan is secured by the mortgages held for sale and is repaid when we sell the underlying mortgage loans to permanent investors. Interest is payable monthly on outstanding advances at the Credit Suisse Cost of Funds, which was 0.43% at April 30, 2014, plus the applicable margin ranging from 2.25% to 2.75% based on the takeout investor, type of loan and the number of days outstanding. As of April 30, 2014 and October 31, 2013, the aggregate principal amount of all borrowings outstanding under the Credit Suisse Master Repurchase Agreement was \$10.4 million and \$27.4 million, respectively.

In February 2014, K. Hovnanian Mortgage executed a new secured Master Repurchase Agreement with Comerica Bank (“Comerica Master Repurchase Agreement”), which was amended on March 26, 2014, that is a short-term borrowing facility that provides up to \$35.0 million through January 7, 2015. The loan is secured by the mortgages held for sale and is repaid when we sell the underlying mortgage loans to permanent investors. Interest is payable monthly at LIBOR, subject to a floor of 0.25%, plus the applicable margin of 2.625%. As of April 30, 2014, the interest rate was 2.875% and the aggregate principal amount of all borrowings outstanding under the Comerica Master Repurchase Agreement was \$4.0 million.

The Chase Master Repurchase Agreement, Customers Master Repurchase Agreement, Credit Suisse Master Repurchase Agreement and Comerica Master Repurchase Agreement (together, the “Master Repurchase Agreements”) require K. Hovnanian Mortgage to satisfy and maintain specified financial ratios and other financial condition tests. Because of the extremely short period of time mortgages are held by K. Hovnanian Mortgage before the mortgages are sold to investors (generally a period of a few weeks), the immateriality to us on a consolidated basis of the size of the Master Repurchase Agreements, the levels required by these financial covenants, our ability based on our immediately available resources to contribute sufficient capital to cure any default, were such conditions to occur, and our right to cure any conditions of default based on the terms of the agreement, we do not consider any of these covenants to be substantive or material. As of April 30, 2014, we believe we were in compliance with the covenants under the Master Repurchase Agreements.

**11. Senior Secured, Senior, Senior Amortizing, Senior Exchangeable and Senior Subordinated Amortizing Notes**

Senior Secured, Senior, Senior Amortizing, Senior Exchangeable and Senior Subordinated Amortizing Notes balances as of April 30, 2014 and October 31, 2013, were as follows:

| (In thousands)   | April 30, October 31, |           |
|--|-----------------------|-----------|
|  | 2014                  | 2013      |
| Senior Secured Notes:  |                       |           |
| 7.25% Senior Secured First Lien Notes due October 15, 2020       | \$577,000             | \$577,000 |
| 9.125% Senior Secured Second Lien Notes due November 15, 2020    | 220,000               | 220,000   |
| 2.0% Senior Secured Notes due November 1, 2021 (net of discount) | 53,123                | 53,119    |
| 5.0% Senior Secured Notes due November 1, 2021 (net of discount) | 129,139               | 128,492   |
| Total Senior Secured Notes                                       | \$979,262             | \$978,611 |
| Senior Notes:  |                       |           |
| 6.25% Senior Notes due January 15, 2015                          | \$-                   | \$21,438  |
| 11.875% Senior Notes due October 15, 2015 (net of discount)      | 60,223                | 60,044    |
| 6.25% Senior Notes due January 15, 2016 (net of discount)        | 172,315               | 172,153   |
| 7.5% Senior Notes due May 15, 2016                               | 86,532                | 86,532    |
| 8.625% Senior Notes due January 15, 2017                         | 121,043               | 121,043   |
| 7.0% Senior Notes due January 15, 2019                           | 150,000               | -         |
| Total Senior Notes   | \$590,113             | \$461,210 |
| 11.0% Senior Amortizing Notes due December 1, 2017               | \$19,004              | \$20,857  |
| Senior Exchangeable Notes due December 1, 2017                   | \$68,336              | \$66,615  |
| 7.25% Senior Subordinated Amortizing Notes due February 15, 2014 | \$-                   | \$2,152   |

Except for K. Hovnanian, the issuer of the notes, our home mortgage subsidiaries, joint ventures and subsidiaries holding interests in our joint ventures, certain of our title insurance subsidiaries and our foreign subsidiary, we and each of our subsidiaries are guarantors of the senior secured, senior, senior amortizing and senior exchangeable notes outstanding at April 30, 2014 (see Note 23). In addition, the 5.0% Senior Secured Notes due 2021 (the "5.0% 2021 Notes") and the 2.0% Senior Secured Notes due 2021 (the "2.0% 2021 Notes" and together with the 5.0% 2021 Notes, the "2021 Notes") are guaranteed by K. Hovnanian JV Holdings, L.L.C. and its subsidiaries except for certain joint ventures and joint venture holding companies (collectively, the "Secured Group"). Members of the Secured Group do not guarantee K. Hovnanian's other indebtedness.

The indentures governing the notes do not contain any financial maintenance covenants, but do contain restrictive covenants that limit, among other things, the Company's ability and that of certain of its subsidiaries, including K. Hovnanian, to incur additional indebtedness (other than certain permitted indebtedness, refinancing indebtedness and nonrecourse indebtedness), pay dividends and make distributions on common and preferred stock, repurchase subordinated indebtedness (with respect to certain of the senior secured and senior notes), make other restricted payments, make investments, sell certain assets, incur liens, consolidate, merge, sell or otherwise dispose of all or substantially all assets, and enter into certain transactions with affiliates. The indentures also contain events of default which would permit the holders of the notes to declare the notes to be immediately due and payable if not cured within applicable grace periods, including the failure to make timely payments on the notes or other material indebtedness, the failure to comply with agreements and covenants and specified events of bankruptcy and insolvency and, with respect to the indentures governing the senior secured notes, the failure of the documents granting security for the senior secured notes to be in full force and effect, and the failure of the liens on any material portion of the collateral securing the senior secured notes to be valid and perfected. As of April 30, 2014, we believe we were in compliance with the covenants of the indentures governing our outstanding notes.



Under the terms of the indentures, we have the right to make certain redemptions and, depending on market conditions and covenant restrictions, may do so from time to time. We also continue to evaluate our capital structure and may also make debt purchases and/or exchanges for debt or equity from time to time through tender offers, open market purchases, private transactions, or otherwise, or seek to raise additional debt or equity capital, depending on market conditions and covenant restrictions.

If our consolidated fixed charge coverage ratio, as defined in the indentures governing our senior secured and senior notes (other than the senior exchangeable notes discussed in Note 13 below), is less than 2.0 to 1.0, we are restricted from making certain payments, including dividends, and from incurring indebtedness other than certain permitted indebtedness, refinancing indebtedness, and nonrecourse indebtedness. As a result of this restriction, we are currently restricted from paying dividends, which are not cumulative, on our 7.625% Series A Preferred Stock. We anticipate we will continue to be restricted from paying dividends for the foreseeable future. Our inability to pay dividends is in accordance with covenant restrictions and will not result in a default under our bond indentures or otherwise affect compliance with any of the covenants contained in the bond indentures.

The 7.25% Senior Secured First Lien Notes due 2020 (the “First Lien Notes”) are secured by a first-priority lien and the 9.125% Senior Secured Second Lien Notes due 2020 (the “Second Lien Notes” and, together with the First Lien Notes, the “2020 Secured Notes”) are secured by a second-priority lien, in each case, subject to permitted liens and other exceptions, on substantially all the assets owned by us, K. Hovnanian and the guarantors of such notes. At April 30, 2014, the aggregate book value of the real property that constituted collateral securing the 2020 Secured Notes was approximately \$625.5 million, which does not include the impact of inventory investments, home deliveries, or impairments thereafter and which may differ from the value if it were appraised. In addition, cash and cash equivalents collateral that secured the 2020 Secured Notes was \$166.9 million as of April 30, 2014, which included \$5.2 million of restricted cash collateralizing certain letters of credit. Subsequent to such date, cash uses include general business operations and real estate and other investments.

The guarantees with respect to the 2021 Notes of the Secured Group are secured, subject to permitted liens and other exceptions, by a first-priority lien on substantially all of the assets of the members of the Secured Group. As of April 30, 2014, the collateral securing the guarantees included (1) \$76.3 million of cash and cash equivalents (subsequent to such date, cash uses include general business operations and real estate and other investments); (2) approximately \$119.2 million aggregate book value of real property of the Secured Group, which does not include the impact of inventory investments, home deliveries, or impairments thereafter and which may differ from the value if it were appraised, and (3) equity interests in guarantors that are members of the Secured Group. Members of the Secured Group also own equity in joint ventures, either directly or indirectly through ownership of joint venture holding companies, with a book value of \$39.3 million as of April 30, 2014; this equity is not pledged to secure, and is not collateral for, the 2021 Notes. Members of the Secured Group are “unrestricted subsidiaries” under K. Hovnanian's other senior secured notes and senior notes, and thus have not guaranteed such indebtedness.

On January 10, 2014, K. Hovnanian issued \$150.0 million aggregate principal amount of 7.0% Senior Notes due 2019, resulting in net proceeds of approximately \$147.8 million. The notes are redeemable in whole or in part at our option at any time prior to July 15, 2016 at 100% of their principal amount plus an applicable “Make-Whole Amount.” We may also redeem some or all of the notes at 103.5% of principal commencing July 15, 2016, at 101.75% of principal commencing January 15, 2017 and 100% of principal commencing January 15, 2018. In addition, we may redeem up to 35% of the aggregate principal amount of the notes prior to July 15, 2016 with the net cash proceeds from certain equity offerings at 107.0% of principal. We used a portion of the net proceeds to fund the redemption on February 9, 2014 (effected on February 10, 2014 which was the next business day after the redemption date) of the remaining outstanding principal amount (\$21.4 million) of our 6.25% Senior Notes due 2015. The redemption resulted in a loss on extinguishment of debt of \$1.2 million, net of the write-off of unamortized fees, and is included in the Condensed Consolidated Statement of Operations as “Loss on extinguishment of debt” for the three and six months ended April 30, 2014. The remaining net proceeds from the offering were used to pay related fees and expenses and for general corporate purposes.

February 15, 2014 was the mandatory settlement date for our Purchase Contracts and was also the payment date for the last quarterly cash installment payment on the Senior Subordinated Amortizing Notes, both of which were initially issued as components of our 7.25% Tangible Equity Units. See Note 12 below for additional information.

## **12. Tangible Equity Units**

On February 9, 2011, we issued an aggregate of 3,000,000 7.25% Tangible Equity Units (the “TEUs”), and on February 14, 2011, we issued an additional 450,000 TEUs pursuant to the over-allotment option granted to the underwriters. Each TEU initially consisted of (i) a prepaid stock purchase contract (each a “Purchase Contract”) and (ii) a senior subordinated amortizing note due February 15, 2014 (each, a “Senior Subordinated Amortizing Note”). Each TEU could be separated into its constituent Purchase Contract and Senior Subordinated Amortizing Note after the initial issuance date of the TEUs, and the separate components could be combined to create a TEU. The Senior Subordinated Amortizing Note component of the TEUs was recorded as debt, and the Purchase Contract component of the TEUs which had a fair value of \$68.1 million was recorded in equity as additional paid in capital.

On each February 15, May 15, August 15 and November 15, K. Hovnanian paid holders of the Senior Subordinated Amortizing Notes equal quarterly cash installments of \$0.453125 per Senior Subordinated Amortizing Note, which cash payments in the aggregate were equivalent to 7.25% per year with respect to each \$25 stated amount of TEUs. Each installment constituted a payment of interest (at a rate of 12.072% per annum) and a partial repayment of principal on the Senior Subordinated Amortizing Notes, allocated as set forth in the amortization schedule provided in the indenture under which the Senior Subordinated Amortizing Notes were issued. The Senior Subordinated Amortizing Notes had a scheduled final installment payment date of February 15, 2014.

The final quarterly cash installment payment of \$0.453125 per Senior Subordinated Amortizing Note was due on February 15, 2014 and was paid to holders thereof on February 18, 2014 (which was the next business day). On February 18, 2014, (which was the first business day after the mandatory settlement date of February 15, 2014) we issued to holders of Purchase Contracts an aggregate of 6,085,224 shares of our Class A Common Stock in settlement of an aggregate of 1,276,933 Purchase Contracts (such amount was based on a settlement rate of 4.7655 shares of Class A Common Stock for each Purchase Contract). In addition, we paid a de minimis amount of cash to holders of the Purchase Contracts in lieu of fractional shares. Accordingly, as of April 30, 2014, we had no Purchase Contracts or Senior Subordinated Amortizing Notes outstanding.

### 13. Senior Exchangeable Notes

On October 2, 2012, the Company and K. Hovnanian issued \$100,000,000 aggregate stated amount of 6.0% Exchangeable Note Units (the “Units”) (equivalent to 100,000 Units). Each \$1,000 stated amount of Units initially consists of (1) a zero coupon Senior Exchangeable note due December 1, 2017 (a “Senior Exchangeable Note”) issued by K. Hovnanian, which bears no cash interest and has an initial principal amount of \$768.51 per Senior Exchangeable Note, and that will accrete to \$1,000 at maturity and (2) a Senior Amortizing note due December 1, 2017 (a “Senior Amortizing Note”) issued by K. Hovnanian, which has an initial principal amount of \$231.49 per Senior Amortizing Note, bears interest at a rate of 11.0% per annum, and has a final installment payment date on December 1, 2017. Each Unit may be separated into its constituent Senior Exchangeable Note and Senior Amortizing Note after the initial issuance date of the Units, and the separate components may be combined to create a Unit.

Each Senior Exchangeable Note had an initial principal amount of \$768.51 (which will accrete to \$1,000 over the term of the Senior Exchangeable Note at an annual rate of 5.17% from the date of issuance, calculated on a semi-annual bond equivalent yield basis). Holders may exchange their Senior Exchangeable Notes at their option at any time prior to 5:00 p.m., New York City time, on the business day immediately preceding December 1, 2017. Each Senior Exchangeable Note will be exchangeable for shares of Class A Common Stock at an initial exchange rate of 185.5288 shares of Class A Common Stock per Senior Exchangeable Note (equivalent to an initial exchange price, based on \$1,000 principal amount at maturity, of approximately \$5.39 per share of Class A Common Stock). The exchange rate will be subject to adjustment in certain events. If certain corporate events occur prior to the maturity date, the Company will increase the applicable exchange rate for any holder who elects to exchange its Senior Exchangeable Notes in connection with such corporate event. In addition, holders of Senior Exchangeable Notes will also have the right to require K. Hovnanian to repurchase such holders’ Senior Exchangeable Notes upon the occurrence of certain of these corporate events. As of April 30, 2014, 18,305 Senior Exchangeable Notes have been converted into 3.4 million shares of our Class A Common Stock, all of which were converted during the first quarter of fiscal 2013.

On each June 1 and December 1 (each, an “installment payment date”) K. Hovnanian will pay holders of Senior Amortizing Notes equal semi-annual cash installments of \$30.00 per Senior Amortizing Note (except for the June 1, 2013 installment payment, which was \$39.83 per Senior Amortizing Note), which cash payment in the aggregate will be equivalent to 6.0% per year with respect to each \$1,000 stated amount of Units. Each installment will constitute a payment of interest (at a rate of 11.0% per annum) and a partial repayment of principal on the Senior Amortizing Note. If certain corporate events occur prior to the maturity date, holders of the Senior Amortizing Notes will have the right to require K. Hovnanian to repurchase such holders’ Senior Amortizing Notes.

### 14. Per Share Calculation

Basic earnings per share is computed by dividing net income (loss) (the “numerator”) by the weighted-average number of common shares outstanding, adjusted for nonvested shares of restricted stock (the “denominator”) for the period. The basic weighted-average number of shares for the three and six months ended April 30, 2014 included 6.1 million shares

related to Purchase Contracts (issued as part of our 7.25% Tangible Equity Units) which, as discussed in Note 12, were all issued upon settlement of the Purchase Contracts in February 2014. Computing diluted earnings per share is similar to computing basic earnings per share, except that the denominator is increased to include the dilutive effects of options and nonvested shares of restricted stock, as well as common shares issuable upon exchange of our Senior Exchangeable Notes issued as part of our 6.0% Exchangeable Note Units. Any options that have an exercise price greater than the average market price are considered to be anti-dilutive and are excluded from the diluted earnings per share calculation.

All outstanding nonvested shares that contain nonforfeitable rights to dividends or dividend equivalents that participate in undistributed earnings with common stock are considered participating securities and are included in computing earnings per share pursuant to the two-class method. The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating securities according to dividends or dividend equivalents and participation rights in undistributed earnings. The Company's restricted common stock ("nonvested shares") are considered participating securities.

Basic and diluted earnings per share for the periods presented below were calculated as follows:

| (In thousands, except per share data)  | Three Months Ended |         | Six Months Ended |            |
|--|--------------------|---------|------------------|------------|
|  | April 30, 2014     | 2013    | April 30, 2014   | 2013       |
| Numerator:   |                    |         |                  |            |
| Net (loss) earnings attributable to Hovnanian                                    | \$(7,902 )         | \$1,318 | \$(32,425 )      | \$(9,990 ) |
| Less: undistributed earnings allocated to nonvested shares                       |                    | (2 )    |                  |            |
| Numerator for basic earnings per share   | (7,902 )           | 1,316   | (32,425 )        | (9,990 )   |
| Plus: undistributed earnings allocated to nonvested shares                       |                    | 2       |                  |            |
| Less: undistributed earnings reallocated to nonvested shares                     |                    | (2 )    |                  |            |
| Numerator for diluted earnings per share   | (7,902 )           | 1,316   | (32,425 )        | (9,990 )   |
| Denominator:   |                    |         |                  |            |
| Denominator for basic earnings per share   | 146,325            | 145,948 | 146,151          | 144,373    |
| Effect of dilutive securities:   |                    |         |                  |            |
| Share based payments   |                    | 1,283   |                  |            |
| Denominator for diluted earnings per share – weighted average shares outstanding | 146,325            | 147,231 | 146,151          | 144,373    |
| Basic earnings per share   | \$(0.05 )          | \$0.01  | \$(0.22 )        | \$(0.07 )  |
| Diluted earnings per share   | \$(0.05 )          | \$0.01  | \$(0.22 )        | \$(0.07 )  |

Incremental shares attributed to nonvested stock and outstanding options to purchase common stock of 0.9 million and 1.0 million for the three and six months ended April 30, 2014, respectively, and 1.4 million for the six months ended April 30, 2013, were excluded from the computation of diluted earnings per share because we had a net loss for the period, and any incremental shares would not be dilutive. Also, 15.2 million shares for both the three and six months ended April 30, 2014 and 16.5 million shares for the six months ended April 30, 2013 of common stock issuable upon the exchange of our Senior Exchangeable Notes were excluded from the computation of diluted earnings per share because we had a net loss for the period.

In addition, shares related to out-of-the-money stock options that could potentially dilute basic earnings per share in the future that were not included in the computation of diluted earnings per share were 2.2 million for the three and six months ended April 30, 2014 and 1.3 million for the three and six months ended April 30, 2013, because to do so would have been anti-dilutive for the periods presented.

## 15. Preferred Stock

On July 12, 2005, we issued 5,600 shares of 7.625% Series A Preferred Stock, with a liquidation preference of \$25,000 per share. Dividends on the Series A Preferred Stock are not cumulative and are paid at an annual rate of

7.625%. The Series A Preferred Stock is not convertible into the Company's common stock and is redeemable in whole or in part at our option at the liquidation preference of the shares. The Series A Preferred Stock is traded as depositary shares, with each depositary share representing 1/1000th of a share of Series A Preferred Stock. The depositary shares are listed on the NASDAQ Global Market under the symbol "HOVNP." During the three and six months ended April 30, 2014 and 2013, we did not pay any dividends on the Series A Preferred Stock due to covenant restrictions in our debt instruments.

## **16. Common Stock**

Each share of Class A Common Stock entitles its holder to one vote per share, and each share of Class B Common Stock generally entitles its holder to ten votes per share. The amount of any regular cash dividend payable on a share of Class A Common Stock will be an amount equal to 110% of the corresponding regular cash dividend payable on a share of Class B Common Stock. If a shareholder desires to sell shares of Class B Common Stock, such stock must be converted into shares of Class A Common Stock.

On August 4, 2008, our Board of Directors adopted a shareholder rights plan (the “Rights Plan”) designed to preserve shareholder value and the value of certain tax assets primarily associated with net operating loss carryforwards (NOL) and built-in losses under Section 382 of the Internal Revenue Code. Our ability to use NOLs and built-in losses would be limited if there was an “ownership change” under Section 382. This would occur if shareholders owning (or deemed under Section 382 to own) 5% or more of our stock increase their collective ownership of the aggregate amount of our outstanding shares by more than 50 percentage points over a defined period of time. The Rights Plan was adopted to reduce the likelihood of an “ownership change” occurring as defined by Section 382. Under the Rights Plan, one right was distributed for each share of Class A Common Stock and Class B Common Stock outstanding as of the close of business on August 15, 2008. Effective August 15, 2008, if any person or group acquires 4.9% or more of the outstanding shares of Class A Common Stock without the approval of the Board of Directors, there would be a triggering event causing significant dilution in the voting power of such person or group. However, existing stockholders who owned, at the time of the Rights Plan’s adoption, 4.9% or more of the outstanding shares of Class A Common Stock will trigger a dilutive event only if they acquire additional shares. The approval of the Board of Directors’ decision to adopt the Rights Plan may be terminated by the Board at any time, prior to the Rights being triggered. The Rights Plan will continue in effect until August 15, 2018, unless it expires earlier in accordance with its terms. The approval of the Board of Directors’ decision to adopt the Rights Plan was submitted to a stockholder vote and approved at a special meeting of stockholders held on December 5, 2008. Also at the Special Meeting on December 5, 2008, our stockholders approved an amendment to our Certificate of Incorporation to restrict certain transfers of Class A Common Stock in order to preserve the tax treatment of our NOLs and built-in losses under Section 382 of the Internal Revenue Code. Subject to certain exceptions pertaining to pre-existing 5% stockholders and Class B stockholders, the transfer restrictions in the amended Certificate of Incorporation generally restrict any direct or indirect transfer (such as transfers of our stock that result from the transfer of interests in other entities that own our stock) if the effect would be to (i) increase the direct or indirect ownership of our stock by any person (or public group) from less than 5% to 5% or more of our common stock; (ii) increase the percentage of our common stock owned directly or indirectly by a person (or public group) owning or deemed to own 5% or more of our common stock; or (iii) create a new public group. Transfers included under the transfer restrictions include sales to persons (or public groups) whose resulting percentage ownership (direct or indirect) of common stock would exceed the 5% thresholds discussed above, or to persons whose direct or indirect ownership of common stock would by attribution cause another person (or public group) to exceed such threshold.

On July 3, 2001, our Board of Directors authorized a stock repurchase program to purchase up to 4 million shares of Class A Common Stock. There were no shares purchased during the three and six months ended April 30, 2014. As of April 30, 2014, the maximum number of shares of Class A Common Stock that may yet be purchased under this program is 0.5 million.

## **17. Income Taxes**

The total income tax expense of \$0.6 million and \$1.2 million recognized for the three and six months ended April 30, 2014, respectively, was primarily due to various state tax expenses and state tax reserves for uncertain state tax positions. The total income tax benefit of \$2.6 million for the three months ended April 30, 2013 was primarily due to a favorable state tax audit settlement, offset slightly by state tax expenses. The total income tax benefit of \$12.1 million recognized for the six months ended April 30, 2013 was primarily due to the release of reserves for a federal tax position that was settled with the Internal Revenue Service and a favorable state tax audit settlement, offset



slightly by state tax expenses.

Deferred federal and state income tax assets primarily represent the deferred tax benefits arising from temporary differences between book and tax income which will be recognized in future years as an offset against future taxable income. If the combination of future years' income (or loss) and the reversal of the timing differences results in a loss, such losses can be carried forward to future years. In accordance with ASC 740, we evaluate our deferred tax assets quarterly to determine if valuation allowances are required. ASC 740 requires that companies assess whether valuation allowances should be established based on the consideration of all available evidence using a "more likely than not" standard. Because of the downturn in the homebuilding industry, resulting in significant inventory and intangible impairments in prior years, we are in a three-year cumulative loss position as of April 30, 2014, a factor which is significant negative evidence in considering whether deferred tax assets are realizable that cannot currently be overcome with other positive evidence. Our valuation allowance for deferred taxes amounted to \$936.3 million and \$927.1 million at April 30, 2014 and October 31, 2013, respectively. The valuation allowance increased during the six months ended April 30, 2014 primarily due to additional valuation allowance recorded for the federal and state tax benefits related to the losses incurred during this period. If, at some time in the future, we determine to reverse all or a portion of our deferred tax asset valuation allowance, such amount would be recorded as an income tax benefit on our consolidated statement of operations, resulting in a material impact to net income and stockholder's equity.

## **18. Operating and Reporting Segments**

Our operating segments are components of our business for which discrete financial information is available and reviewed regularly by the chief operating decision-maker, our Chief Executive Officer, to evaluate performance and make operating decisions. Based on this criteria, each of our communities qualifies as an operating segment, and therefore, it is impractical to provide segment disclosures for this many segments. As such, we have aggregated the homebuilding operating segments into six reportable segments.

Our homebuilding operating segments are aggregated into reportable segments based primarily upon geographic proximity, similar regulatory environments, land acquisition characteristics and similar methods used to construct and sell homes. The Company's reportable segments consist of the following six homebuilding segments and a financial services segment:

### Homebuilding:

- (1) Northeast (New Jersey and Pennsylvania)
- (2) Mid-Atlantic (Delaware, Maryland, Virginia, Washington D.C. and West Virginia)
- (3) Midwest (Illinois, Minnesota and Ohio)



(4) Southeast (Florida, Georgia, North Carolina and South Carolina)

(5) Southwest (Arizona and Texas)

(6) West (California)

#### Financial Services

Operations of the Company's Homebuilding segments primarily include the sale and construction of single-family attached and detached homes, attached townhomes and condominiums, urban infill and active adult homes in planned residential developments. In addition, from time to time, operations of the homebuilding segments include sales of land. Operations of the Company's Financial Services segment include mortgage banking and title services provided to the homebuilding operations' customers. We do not retain or service mortgages that we originate but rather sell the mortgages and related servicing rights to investors.

Corporate and unallocated primarily represents operations at our headquarters in Red Bank, New Jersey. This includes our executive offices, information services, human resources, corporate accounting, training, treasury, process redesign, internal audit, construction services, and administration of insurance, quality, and safety. It also includes interest income and interest expense resulting from interest incurred that cannot be capitalized in inventory in the Homebuilding segments, as well as the gains or losses on extinguishment of debt from debt repurchases or exchanges.

Evaluation of segment performance is based primarily on operating earnings from continuing operations before provision for income taxes. Income before income taxes for the Homebuilding segments consists of revenues generated from the sales of homes and land, income from unconsolidated entities, management fees and other income, less the cost of homes and land sold, selling, general and administrative expenses, interest expense and noncontrolling interest expense. Income before income taxes for the Financial Services segment consists of revenues generated from mortgage financing, title insurance and closing services, less the cost of such services and certain selling, general and administrative expenses incurred by the Financial Services segment.

Operational results of each segment are not necessarily indicative of the results that would have occurred had the segment been an independent stand-alone entity during the periods presented.

Financial information relating to the Company's segment operations was as follows:



| (In thousands)                            | Three Months Ended |            | Six Months Ended  |             |
|---|--------------------|------------|-------------------|-------------|
|   | April 30,<br>2014  | 2013       | April 30,<br>2014 | 2013        |
| <b>Revenues:</b>                          |                    |            |                   |             |
| Northeast                                 | \$65,745           | \$54,236   | \$118,998         | \$109,071   |
| Mid-Atlantic                              | 68,735             | 58,405     | 129,255           | 111,124     |
| Midwest                                   | 48,703             | 39,393     | 92,461            | 71,726      |
| Southeast                                 | 52,023             | 37,192     | 91,164            | 66,153      |
| Southwest                                 | 164,633            | 161,813    | 293,210           | 293,437     |
| West                                      | 40,708             | 61,326     | 71,458            | 107,429     |
| Total homebuilding                        | 440,547            | 412,365    | 796,546           | 758,940     |
| Financial services                        | 9,412              | 10,682     | 17,506            | 22,341      |
| Corporate and unallocated                 | (30 )              | (49 )      | (75 )             | (72 )       |
| Total revenues                            | \$449,929          | \$422,998  | \$813,977         | \$781,209   |
| <b>(Loss) income before income taxes:</b> |                    |            |                   |             |
| Northeast                                 | \$(2,759 )         | \$(4,651 ) | \$(8,820 )        | \$(9,538 )  |
| Mid-Atlantic                              | 2,462              | 3,344      | 4,375             | 4,269       |
| Midwest                                   | 3,361              | 2,279      | 5,716             | 3,479       |
| Southeast                                 | 3,315              | 2,719      | 4,746             | 3,309       |
| Southwest                                 | 15,676             | 16,538     | 26,081            | 24,641      |
| West                                      | 2,097              | 2,422      | 1,738             | 1,327       |
| Homebuilding income before income taxes   | 24,152             | 22,651     | 33,836            | 27,487      |
| Financial services                        | 2,705              | 3,545      | 4,127             | 7,776       |
| Corporate and unallocated                 | (34,155 )          | (27,461 )  | (69,151 )         | (57,330 )   |
| Loss before income taxes                  | \$(7,298 )         | \$(1,265 ) | \$(31,188 )       | \$(22,067 ) |

| (In thousands)            | April 30,<br>2014 | October 31,<br>2013 |
|---------------------------|-------------------|---------------------|
| <b>Assets:</b>            |                   |                     |
| Northeast                 | \$313,866         | \$323,152           |
| Mid-Atlantic              | 295,251           | 240,486             |
| Midwest                   | 134,722           | 104,596             |
| Southeast                 | 125,582           | 101,410             |
| Southwest                 | 409,672           | 305,878             |
| West                      | 154,802           | 130,545             |
| Total homebuilding        | 1,433,895         | 1,206,067           |
| Financial services        | 84,682            | 148,853             |
| Corporate and unallocated | 320,246           | 404,210             |
| Total assets              | \$1,838,823       | \$1,759,130         |



## **19. Variable Interest Entities**

The Company enters into land and lot option purchase contracts to procure land or lots for the construction of homes. Under these contracts, the Company will fund a stated deposit in consideration for the right, but not the obligation, to purchase land or lots at a future point in time with predetermined terms. Under the terms of the option purchase contracts, many of the option deposits are not refundable at the Company's discretion. Under the requirements of ASC 810, certain option purchase contracts may result in the creation of a variable interest in the entity ("VIE") that owns the land parcel under option.

In compliance with ASC 810, the Company analyzes its option purchase contracts to determine whether the corresponding land sellers are VIEs and, if so, whether the Company is the primary beneficiary. Although the Company does not have legal title to the underlying land, ASC 810 requires the Company to consolidate a VIE if the Company is determined to be the primary beneficiary. In determining whether it is the primary beneficiary, the Company considers, among other things, whether it has the power to direct the activities of the VIE that most significantly impact the VIE's economic performance. Such activities would include, among other things, determining or limiting the scope or purpose of the VIE, selling or transferring property owned or controlled by the VIE, or arranging financing for the VIE. The Company also considers whether it has the obligation to absorb losses of the VIE or the right to receive benefits from the VIE. As a result of its analyses, the Company determined that as of April 30, 2014 and October 31, 2013 it was not the primary beneficiary of any VIEs from which it is purchasing land under option purchase contracts.

We will continue to secure land and lots using options, some of which are with VIEs. Including deposits on our unconsolidated VIEs, at April 30, 2014, we had total cash and letters of credit deposits amounting to approximately \$73.1 million to purchase land and lots with a total purchase price of \$1.2 billion. The maximum exposure to loss with respect to our land and lot options is limited to the deposits plus any pre-development costs invested in the property, although some deposits are refundable at our request or refundable if certain conditions are not met.

## **20. Investments in Unconsolidated Homebuilding and Land Development Joint Ventures**

We enter into homebuilding and land development joint ventures from time to time as a means of accessing lot positions, expanding our market opportunities, establishing strategic alliances, managing our risk profile, leveraging our capital base and enhancing returns on capital. Our homebuilding joint ventures are generally entered into with third-party investors to develop land and construct homes that are sold directly to third-party homebuyers. Our land development joint ventures include those entered into with developers and other homebuilders as well as financial investors to develop finished lots for sale to the joint venture's members or other third parties.

The tables set forth below summarize the combined financial information related to our unconsolidated homebuilding and land development joint ventures that are accounted for under the equity method.





| (Dollars in thousands)                   | April 30, 2014 |                     |           |   |
|--|----------------|---------------------|-----------|---|
|  | Homebuilding   | Land<br>Development | Total     |   |
| Assets:                                  |                |                     |           |   |
| Cash and cash equivalents                | \$23,812       | \$377               | \$24,189  |   |
| Inventories                              | 109,491        | 9,670               | 119,161   |   |
| Other assets                             | 5,697          | -                   | 5,697     |   |
| Total assets                             | \$139,000      | \$10,047            | \$149,047 |   |
| Liabilities and equity:                  |                |                     |           |   |
| Accounts payable and accrued liabilities | \$30,890       | \$2,837             | \$33,727  |   |
| Notes payable                            | 18,370         | -                   | 18,370    |   |
| Total liabilities                        | 49,260         | 2,837               | 52,097    |   |
| Equity of:                               |                |                     |           |   |
| Hovnianian Enterprises, Inc.             | 39,302         | 2,795               | 42,097    |   |
| Others                                   | 50,438         | 4,415               | 54,853    |   |
| Total equity                             | 89,740         | 7,210               | 96,950    |   |
| Total liabilities and equity             | \$139,000      | \$10,047            | \$149,047 |   |
| Debt to capitalization ratio             | 17             | % 0                 | % 16      | % |

| (Dollars in thousands)                   | October 31, 2013 |                     |           |   |
|--|------------------|---------------------|-----------|---|
|  | Homebuilding     | Land<br>Development | Total     |   |
| Assets:                                  |                  |                     |           |   |
| Cash and cash equivalents                | \$30,102         | \$639               | \$30,741  |   |
| Inventories                              | 101,735          | 11,080              | 112,815   |   |
| Other assets                             | 6,868            | -                   | 6,868     |   |
| Total assets                             | \$138,705        | \$11,719            | \$150,424 |   |
| Liabilities and equity:                  |                  |                     |           |   |
| Accounts payable and accrued liabilities | \$28,016         | \$4,047             | \$32,063  |   |
| Notes payable                            | 23,904           | -                   | 23,904    |   |
| Total liabilities                        | 51,920           | 4,047               | 55,967    |   |
| Equity of:                               |                  |                     |           |   |
| Hovnianian Enterprises, Inc.             | 44,141           | 2,703               | 46,844    |   |
| Others                                   | 42,644           | 4,969               | 47,613    |   |
| Total equity                             | 86,785           | 7,672               | 94,457    |   |
| Total liabilities and equity             | \$138,705        | \$11,719            | \$150,424 |   |
| Debt to capitalization ratio             | 22               | % 0                 | % 20      | % |

As of April 30, 2014 and October 31, 2013, we had advances outstanding of approximately \$5.6 million and \$4.6 million, respectively, to these unconsolidated joint ventures, which were included in the "Accounts payable and accrued liabilities" balances in the tables above. On our Condensed Consolidated Balance Sheets our "Investments in and advances to unconsolidated joint ventures" amounted to \$47.7 million and \$51.4 million at April 30, 2014 and October 31, 2013, respectively. In some cases, our net investment in these joint ventures is less than our proportionate share of the equity reflected in the tables above because of the differences between asset impairments recorded against

our joint venture investments and any impairments recorded in the applicable joint venture. Impairments of our joint venture equity investments are recorded when we deem a decline in fair value to be other than temporary while impairments recorded in the joint ventures are recorded when undiscounted cash flows of its community indicate that the carrying amount is not recoverable. During fiscal 2013 and the first six months of fiscal 2014, we did not write down any joint venture investments based on our determination that none of the investments of our joint ventures sustained any impairment during those periods.

| (In thousands)                  | For the Three Months Ended April 30, 2014 |                  |             |
|---------------------------------|---|------------------|-------------|
|                                 | Homebuilding                              | Land Development | Total       |
| Revenues                        | \$33,746                                  | \$3,355          | \$37,101    |
| Cost of sales and expenses      | (31,644                                   | ) (3,466         | ) (35,110 ) |
| Joint venture net income (loss) | \$2,102                                   | \$(111           | ) \$1,991   |
| Our share of net income (loss)  | \$1,030                                   | \$(55            | ) \$975     |

| (In thousands)             | For the Three Months Ended April 30, 2013 |                  |             |
|----------------------------|---|------------------|-------------|
|                            | Homebuilding                              | Land Development | Total       |
| Revenues                   | \$74,423                                  | \$1,661          | \$76,084    |
| Cost of sales and expenses | (70,826                                   | ) (1,506         | ) (72,332 ) |
| Joint venture net income   | \$3,597                                   | \$155            | \$3,752     |
| Our share of net income    | \$807                                     | \$78             | \$885       |

| (In thousands)             | For the Six Months Ended April 30, 2014 |                  |             |
|----------------------------|---|------------------|-------------|
|                            | Homebuilding                            | Land Development | Total       |
| Revenues                   | \$85,019                                | \$5,269          | \$90,288    |
| Cost of sales and expenses | (77,725                                 | ) (5,085         | ) (82,810 ) |
| Joint venture net income   | \$7,294                                 | \$184            | \$7,478     |
| Our share of net income    | \$3,577                                 | \$92             | \$3,669     |

| (In thousands)             | For the Six Months Ended April 30, 2013 |                  |              |
|----------------------------|---|------------------|--------------|
|                            | Homebuilding                            | Land Development | Total        |
| Revenues                   | \$134,566                               | \$9,475          | \$144,041    |
| Cost of sales and expenses | (127,115                                | ) (4,455         | ) (131,570 ) |
| Joint venture net income   | \$7,451                                 | \$5,020          | \$12,471     |
| Our share of net income    | \$716                                   | \$2,510          | \$3,226      |

“Income from unconsolidated joint ventures” is reflected as a separate line in the accompanying Condensed Consolidated Statements of Operations and reflects our proportionate share of the income or loss of these unconsolidated homebuilding and land development joint ventures. The difference between our share of the income or loss from these unconsolidated joint ventures disclosed in the tables above compared to the Condensed Consolidated Statements of Operations for the three and six months ended April 30, 2014 and 2013 is due primarily to the reclassification of the intercompany portion of management fee income from certain joint ventures (discussed below) and the deferral of income for lots purchased by us from certain joint ventures. To compensate us for the administrative services we provide as the manager of certain joint ventures, we receive a management fee based on a percentage of the applicable joint venture’s revenues. These management fees, which totaled \$1.6 million and \$2.7

million, for the three months ended April 30, 2014 and 2013, respectively, and \$3.7 million and \$5.5 million for the six months ended April 30, 2014 and 2013, respectively, are recorded in "Homebuilding: Selling, general and administrative" on the Condensed Consolidated Statement of Operations.

In determining whether or not we must consolidate joint ventures that we manage, we assess whether the other partners have specific rights to overcome the presumption of control by us as the manager of the joint venture. In most cases, the presumption is overcome because the joint venture agreements require that both partners agree on establishing the operations and capital decisions of the partnership, including budgets in the ordinary course of business.

Typically, our unconsolidated joint ventures obtain separate project specific mortgage financing. The amount of financing is generally targeted to be no more than 50% of the joint venture's total assets. For our more recent joint ventures, obtaining financing has become challenging, therefore, some of our joint ventures are capitalized only with equity. Including the impact of impairments recorded by the joint ventures, the total debt to capitalization ratio of all our joint ventures as of April 30, 2014 was 16%. Any joint venture financing is on a nonrecourse basis, with guarantees from us limited only to performance and completion of development, environmental warranties and indemnification, standard indemnification for fraud, misrepresentation and other similar actions, including a voluntary bankruptcy filing. In some instances, the joint venture entity is considered a VIE under ASC 810-10 "Consolidation – Overall" due to the returns being capped to the equity holders; however, in these instances, we are not the primary beneficiary, and therefore we do not consolidate these entities.

## 21. Recent Accounting Pronouncements

In January 2014, the Financial Accounting Standards Board issued Accounting Standards Update No. 2014-04, “Receivables - Troubled Debt Restructurings by Creditors,” which clarifies when an in substance repossession or foreclosure of residential real estate property collateralizing a consumer mortgage loan has occurred. By doing so, this guidance helps determine when the creditor should derecognize the loan receivable and recognize the real estate property. The guidance is effective for the Company beginning November 1, 2015 and is not expected to have a material impact on the Company’s Condensed Consolidated Financial Statements.

## 22. Fair Value of Financial Instruments

ASC 820, “Fair Value Measurements and Disclosures,” provides a framework for measuring fair value, expands disclosures about fair-value measurements and establishes a fair-value hierarchy which prioritizes the inputs used in measuring fair value summarized as follows:

Level 1                      Fair value determined based on quoted prices in active markets for identical assets.

Level 2                      Fair value determined using significant other observable inputs.

Level 3                      Fair value determined using significant unobservable inputs.

Our financial instruments measured at fair value on a recurring basis are summarized below:

| (In thousands)                   | Fair Value Hierarchy | Fair Value at  | Fair Value at    |
|----------------------------------|----------------------|----------------|------------------|
|                                  |                      | April 30, 2014 | October 31, 2013 |
| Mortgage loans held for sale (1) | Level 2              | \$58,317       | \$113,739        |
| Interest rate lock commitments   | Level 2              | 171            | 369              |
| Forward contracts                | Level 2              | (469           | ) (1,155         |
|                                  |                      | \$58,019       | \$112,953        |

(1) The aggregate unpaid principal balance was \$54.6 million and \$107.7 million at April 30, 2014 and October 31, 2013, respectively.

We elected the fair value option for our loans held for sale for mortgage loans originated subsequent to October 31, 2008 in accordance with ASC 825, "Financial Instruments," which permits us to measure financial instruments at fair value on a contract-by-contract basis. Management believes that the election of the fair value option for loans held for sale improves financial reporting by mitigating volatility in reported earnings caused by measuring the fair value of the loans and the derivative instruments used to economically hedge them without having to apply complex hedge accounting provisions. In addition, the fair value of servicing rights is included in the Company's loans held for sale as of April 30, 2014. Fair value of the servicing rights is determined based on values in the Company's servicing sales contracts. Fair value of loans held for sale is based on independent quoted market prices, where available, or the prices for other mortgage whole loans with similar characteristics.

The Financial Services segment had a pipeline of loan applications in process of \$489.5 million at April 30, 2014. Loans in process for which interest rates were committed to the borrowers totaled approximately \$40.0 million as of April 30, 2014. Substantially all of these commitments were for periods of 60 days or less. Since a portion of these commitments is expected to expire without being exercised by the borrowers, the total commitments do not necessarily represent future cash requirements.

The Financial Services segment uses investor commitments and forward sales of mandatory mortgage-backed securities ("MBS") to hedge its mortgage-related interest rate exposure. These instruments involve, to varying degrees, elements of credit and interest rate risk. Credit risk is managed by entering into MBS forward commitments, option contracts with investment banks, federally regulated bank affiliates and loan sales transactions with permanent investors meeting the segment's credit standards. The segment's risk, in the event of default by the purchaser, is the difference between the contract price and fair value of the MBS forward commitments and option contracts. At April 30, 2014, the segment had open commitments amounting to \$22.5 million to sell MBS with varying settlement dates through June 12, 2014.

The assets accounted for using the fair value option are initially measured at fair value. Gains and losses from initial measurement and subsequent changes in fair value are recognized in the Financial Services segment's income. The changes in fair values that are included in income are shown, by financial instrument and financial statement line item, below:

|   |  |           |   | Three Months Ended April 30, 2014 |               |             |
|---|--|-----------|---|-----------------------------------|---------------|-------------|
|   |  |           |   | Mortgage                          |               |             |
|   |  |           |   |                                   | Interest Rate |             |
| (In thousands)  |  | Loans     |   | Lock                              | Forward       |             |
|   |  | Held      |   | Commitments                       | Contracts     |             |
|   |  | For Sale  |   |                                   |               |             |
| Changes in fair value included in net loss all reflected in financial services revenues |  | \$ (465   | ) | \$ (78                            | )             | \$ 599      |
|   |  |           |   |                                   |               |             |
|   |  |           |   | Three Months Ended April 30, 2013 |               |             |
|   |  |           |   | Mortgage                          |               |             |
|   |  |           |   |                                   | Interest Rate |             |
| (In thousands)  |  | Loans     |   | Lock                              | Forward       |             |
|   |  | Held      |   | Commitments                       | Contracts     |             |
|   |  | For Sale  |   |                                   |               |             |
| Changes in fair value included in net loss all reflected in financial services revenues |  | \$ 1,776  |   | \$ 480                            |               | \$ (1,668 ) |
|   |  |           |   |                                   |               |             |
|   |  |           |   | Six Months Ended April 30, 2014   |               |             |
|   |  |           |   | Mortgage                          |               |             |
|   |  |           |   |                                   | Interest Rate |             |
| (In thousands)  |  | Loans     |   | Lock                              | Forward       |             |
|   |  | Held      |   | Commitments                       | Contracts     |             |
|   |  | For Sale  |   |                                   |               |             |
| Changes in fair value included in net loss all reflected in financial services revenues |  | \$ (1,889 | ) | \$ (198                           | )             | \$ 686      |

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| (In thousands)  | Six Months Ended April 30, 2013 |                                |                   |
|---|---------------------------------|--------------------------------|-------------------|
|   | Mortgage                        |                                |                   |
|   | Loans Held For Sale             | Interest Rate Lock Commitments | Forward Contracts |
| Changes in fair value included in net loss all reflected in financial services revenues | \$738                           | \$272                          | \$(1,464 )        |

The Company's assets measured at fair value on a nonrecurring basis are those assets for which the Company has recorded valuation adjustments and write-offs during the periods presented. The assets measured at fair value on a nonrecurring basis are all within the Company's Homebuilding operations and are summarized below:

Nonfinancial Assets

| (In thousands)  | Fair Value Hierarchy | Three Months Ended April 30, 2014 |              |            |
|---|----------------------|-----------------------------------|--------------|------------|
|   |                      | Pre-Impairment Amount             | Total Losses | Fair Value |
| Sold and unsold homes and lots under development          | Level 3              | \$-                               | \$-          | \$-        |
| Land and land options held for future development or sale | Level 3              | \$236                             | \$(82 )      | \$154      |



| (In thousands)  | Fair Value<br>Hierarchy | Three Months Ended<br>April 30, 2013 |                       | Total<br>Losses | Fair<br>Value |
|---|-------------------------|--------------------------------------|-----------------------|-----------------|---------------|
|   |                         | Fair Value                           | Pre-Impairment Amount |                 |               |
| Sold and unsold homes and lots under development          | Level 3                 | \$2,348                              |                       | \$(910 )        | \$1,438       |
| Land and land options held for future development or sale | Level 3                 | \$-                                  |                       | \$-             | \$-           |

| (In thousands)  | Fair Value<br>Hierarchy | Six Months Ended<br>April 30, 2014 |                       | Total<br>Losses | Fair<br>Value |
|---|-------------------------|------------------------------------|-----------------------|-----------------|---------------|
|   |                         | Fair Value                         | Pre-Impairment Amount |                 |               |
| Sold and unsold homes and lots under development          | Level 3                 | \$-                                |                       | \$-             | \$-           |
| Land and land options held for future development or sale | Level 3                 | \$236                              |                       | \$(82 )         | \$154         |

| (In thousands)  | Fair Value<br>Hierarchy | Six Months Ended<br>April 30, 2013 |                       | Total<br>Losses | Fair<br>Value |
|---|-------------------------|------------------------------------|-----------------------|-----------------|---------------|
|   |                         | Fair Value                         | Pre-Impairment Amount |                 |               |
| Sold and unsold homes and lots under development          | Level 3                 | \$5,243                            |                       | \$(1,478 )      | \$3,765       |
| Land and land options held for future development or sale | Level 3                 | \$485                              |                       | \$(19 )         | \$466         |

We record impairment losses on inventories related to communities under development and held for future development when events and circumstances indicate that they may be impaired and the undiscounted cash flows estimated to be generated by those assets are less than their related carrying amounts. If the expected undiscounted cash flows are less than the carrying amount, then the community is written down to its fair value. We estimate the fair value of each impaired community by determining the present value of its estimated future cash flows at a discount rate commensurate with the risk of the respective community. Should the estimates or expectations used in determining cash flows or fair value decrease or differ from current estimates in the future, we may be required to recognize additional impairments. We recorded inventory impairments, which are included in the Condensed Consolidated Statements of Operations as "Inventory impairment loss and land option write-offs" and deducted from inventory, of \$0.1 million for both the three and six months ended April 30, 2014, and \$0.9 million and \$1.5 million for the three and six months ended April 30, 2013, respectively.

The fair value of our cash equivalents and restricted cash approximates their carrying amount, based on Level 1 inputs.

The fair value of each series of the senior unsecured notes (other than the 7.0% Senior Notes due 2019 (the “2019 Notes”), the senior exchangeable notes and the senior amortizing notes) and senior subordinated amortizing notes is estimated based on recent trades or quoted market prices for the same issues or based on recent trades or quoted market prices for our debt of similar security and maturity to achieve comparable yields, which are Level 2 measurements. The fair value of the senior unsecured notes (all series in the aggregate), other than the 2019 Notes, senior exchangeable notes and senior amortizing notes, was estimated at \$477.3 million as of April 30, 2014. As of April 30, 2014, the senior subordinated amortizing notes were no longer outstanding. As of October 31, 2013, the fair value of the senior unsecured notes (all series in the aggregate), other than the senior exchangeable notes and senior amortizing notes, and senior subordinated amortizing notes, was estimated at \$493.4 million and \$2.2 million, respectively. The 2019 Notes were not issued as of October 31, 2013.

The fair value of each of the 2019 Notes, the senior secured notes (all series in the aggregate), the senior amortizing notes and the senior exchangeable notes is estimated based on third party broker quotes, a Level 3 measurement. The fair value of the 2019 Notes, senior secured notes (all series in the aggregate), the senior amortizing notes and the senior exchangeable notes was estimated at \$153.0 million, \$1.0 billion, \$19.0 million and \$92.0 million, respectively, as of April 30, 2014. As of October 31, 2013, the fair value of the senior secured notes (all series in the aggregate), senior amortizing notes and senior exchangeable notes was estimated at \$1.0 billion, \$20.9 million and \$86.8 million, respectively. The 2019 Notes were not issued as of October 31, 2013.

**23. Financial Information of Subsidiary Issuer and Subsidiary Guarantors**

Hovnianian Enterprises, Inc., the parent company (the “Parent”), is the issuer of publicly traded common stock and preferred stock, which is represented by depository shares. One of its wholly owned subsidiaries, K. Hovnianian Enterprises, Inc. (the “Subsidiary Issuer”), acts as a finance entity that, as of April 30, 2014, had issued and outstanding approximately \$992.0 million of senior secured notes (\$979.3 million, net of discount), \$591.1 million senior notes (\$590.1 million, net of discount), \$19.0 million senior amortizing notes and \$68.3 million senior exchangeable notes (issued as components of our 6.0% Exchangeable Note Units). The senior secured notes, senior notes, senior amortizing notes and senior exchangeable notes are fully and unconditionally guaranteed by the Parent.

In addition to the Parent, each of the wholly owned subsidiaries of the Parent other than the Subsidiary Issuer (collectively, “Guarantor Subsidiaries”), with the exception of our home mortgage subsidiaries, certain of our title insurance subsidiaries, joint ventures, subsidiaries holding interests in our joint ventures and our foreign subsidiary (collectively, the “Nonguarantor Subsidiaries”), have guaranteed fully and unconditionally, on a joint and several basis, the obligations of the Subsidiary Issuer to pay principal and interest under the senior secured notes (other than the 2021 Notes), senior notes, senior exchangeable notes and senior amortizing notes. The Guarantor Subsidiaries are directly or indirectly 100% owned subsidiaries of the Parent. The 2021 Notes are guaranteed by the Guarantor Subsidiaries and the members of the Secured Group (see Note 11).

The senior unsecured notes (except for the 2019 Notes), senior amortizing notes and senior exchangeable notes have been registered under the Securities Act of 1933, as amended. The 2019 Notes, 2020 Secured Notes and the 2021 Notes (see Note 11) are not, pursuant to the indentures under which such notes were issued, required to be registered. The Condensed Consolidating Financial Statements presented below are in respect of our registered notes only and not the 2019 Notes, 2020 Secured Notes or the 2021 Notes (however, the Guarantor Subsidiaries for the 2019 Notes and the 2020 Secured Notes are the same as those represented by the accompanying Condensed Consolidating Financial Statements). In lieu of providing separate financial statements for the Guarantor Subsidiaries of our registered notes, we have included the accompanying Condensed Consolidating Financial Statements. Therefore, separate financial statements and other disclosures concerning such Guarantor Subsidiaries are not presented.

The following Condensed Consolidating Financial Statements present the results of operations, financial position and cash flows of (i) the Parent, (ii) the Subsidiary Issuer, (iii) the Guarantor Subsidiaries, (iv) the Nonguarantor Subsidiaries and (v) the eliminations to arrive at the information for Hovnianian Enterprises, Inc. on a consolidated basis.

## HOVNANIAN ENTERPRISES, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## CONDENSED CONSOLIDATING BALANCE SHEET

APRIL 30, 2014

(In Thousands)

|  | Parent     | Subsidiary<br>Issuer | Guarantor<br>Subsidiaries | Nonguarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|------------|----------------------|---------------------------|------------------------------|--------------|--------------|
| <b>ASSETS:</b>   |            |                      |                           |                              |              |              |
| Homebuilding   |            | \$191,410            | \$1,264,666               | \$314,593                    | (16,528 )    | \$1,754,141  |
| Financial services   |            |                      | 12,182                    | 72,500                       |              | 84,682       |
| Intercompany receivable<br>(payable)                                       |            | 1,291,281            |                           | 26,236                       | (1,317,517 ) | -            |
| Investments in and<br>amounts due to and from<br>consolidated subsidiaries | (94,617 )  | (21,749 )            | 312,298                   |                              | (195,932 )   | -            |
| Total assets   | \$(94,617) | \$1,460,942          | \$1,589,146               | \$413,329                    | (1,529,977 ) | \$1,838,823  |
| <b>LIABILITIES AND<br/>EQUITY:</b>   |            |                      |                           |                              |              |              |
| Homebuilding   | \$2,211    | \$176                | \$494,285                 | \$49,928                     |              | \$546,600    |
| Financial services   |            |                      | 11,902                    | 50,424                       |              | 62,326       |
| Notes payable  |            | 1,685,332            | 3,423                     | 232                          |              | 1,688,987    |
| Intercompany payable   | 327,508    |                      | 1,034,657                 |                              | (1,362,165 ) | -            |
| Income taxes payable<br>(receivable)                                       | 38,624     |                      | (35,201 )                 |                              |              | 3,423        |
| Stockholders' (deficit)<br>equity  | (462,960)  | (224,566 )           | 80,080                    | 312,298                      | (167,812 )   | (462,960 )   |
| Noncontrolling interest in<br>consolidated joint ventures                  |            |                      |                           | 447                          |              | 447          |
| Total liabilities and equity   | \$(94,617) | \$1,460,942          | \$1,589,146               | \$413,329                    | (1,529,977 ) | \$1,838,823  |

## HOVNANIAN ENTERPRISES, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## CONDENSED CONSOLIDATING BALANCE SHEET

OCTOBER 31, 2013

(In Thousands)

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|  | Parent     | Subsidiary<br>Issuer | Guarantor<br>Subsidiaries | Nonguarantor<br>Subsidiaries | Eliminations   | Consolidated |
|--|------------|----------------------|---------------------------|------------------------------|----------------|--------------|
| <b>ASSETS:</b>   |            |                      |                           |                              |                |              |
| Homebuilding   |            | \$277,800            | \$1,020,435               | \$312,042                    |                | \$1,610,277  |
| Financial services   |            |                      | 14,570                    | 134,283                      |                | 148,853      |
| Intercompany receivable  |            | 1,093,906            |                           | 14,489                       | (1,108,395 )   | -            |
| Investments in and<br>amounts due to and from<br>consolidated subsidiaries | (62,298 )  | 2,275                | 286,216                   |                              | (226,193 )     | -            |
| Total assets   | \$(62,298) | \$1,373,981          | \$1,321,221               | \$460,814                    | \$(1,334,588 ) | \$1,759,130  |
| <b>LIABILITIES AND<br/>EQUITY:</b>   |            |                      |                           |                              |                |              |
| Homebuilding   | \$3,798    | \$491                | \$437,767                 | \$64,329                     |                | \$506,385    |
| Financial services   |            |                      | 14,789                    | 109,748                      |                | 124,537      |
| Notes payable  |            | 1,555,336            | 2,276                     | 94                           |                | 1,557,706    |
| Intercompany payable   | 326,262    |                      | 805,774                   |                              | (1,132,036 )   | -            |
| Income taxes payable<br>(receivable)                                       | 40,868     |                      | (37,567 )                 |                              |                | 3,301        |
| Stockholders' (deficit)<br>equity  | (433,226)  | (181,846 )           | 98,182                    | 286,216                      | (202,552 )     | (433,226 )   |
| Noncontrolling interest in<br>consolidated joint ventures                  |            |                      |                           | 427                          |                | 427          |
| Total liabilities and equity   | \$(62,298) | \$1,373,981          | \$1,321,221               | \$460,814                    | \$(1,334,588 ) | \$1,759,130  |

## HOVNIANIAN ENTERPRISES, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS

THREE MONTHS ENDED APRIL 30, 2014

(In Thousands)

|   | Parent    | Subsidiary<br>Issuer | Guarantor<br>Subsidiaries | Nonguarantor<br>Subsidiaries | Eliminations | Consolidated |   |
|---|-----------|----------------------|---------------------------|------------------------------|--------------|--------------|---|
| Revenues:   |           |                      |                           |                              |              |              |   |
| Homebuilding  |           | \$(31                | ) \$366,152               | \$74,396                     |              | \$440,517    |   |
| Financial services                                      |           |                      | 2,236                     | 7,176                        |              | 9,412        |   |
| Intercompany charges                                    |           | 25,978               | (27,019                   | ) 249                        | 792          | -            |   |
| Total revenues  | -         | 25,947               | 341,369                   | 81,821                       | 792          | 449,929      |   |
| Expenses:   |           |                      |                           |                              |              |              |   |
| Homebuilding  | 1,942     | 33,629               | 349,322                   | 67,129                       | (1,590       | ) 450,432    |   |
| Financial services                                      | 5         |                      | 1,694                     | 5,008                        |              | 6,707        |   |
| Total expenses  | 1,947     | 33,629               | 351,016                   | 72,137                       | (1,590       | ) 457,139    |   |
| Loss on extinguishment of<br>debt                       |           | (1,155               | )                         |                              |              | (1,155       | ) |
| Income from<br>unconsolidated joint<br>ventures         |           |                      | 37                        | 1,030                        |              | 1,067        |   |
| (Loss) income before<br>income taxes                    | (1,947    | ) (8,837             | ) (9,610                  | ) 10,714                     | 2,382        | (7,298       | ) |
| State and federal income<br>tax (benefit) provision     | (2,236    | )                    | 2,840                     |                              |              | 604          |   |
| Equity in (loss) income of<br>consolidated subsidiaries | (8,191    | ) (11,945            | ) 10,714                  |                              | 9,422        | -            |   |
| Net (loss) income                                       | \$(7,902) | \$(20,782            | ) \$(1,736                | ) \$10,714                   | \$11,804     | \$(7,902     | ) |

## HOVNIANIAN ENTERPRISES, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS

THREE MONTHS ENDED APRIL 30, 2013

(In Thousands)

|  | Parent | Subsidiary<br>Issuer | Guarantor<br>Subsidiaries | Nonguarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|--------|----------------------|---------------------------|------------------------------|--------------|--------------|
|--|--------|----------------------|---------------------------|------------------------------|--------------|--------------|

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|   |         |           |             |          |          |             |   |
|---|---------|-----------|-------------|----------|----------|-------------|---|
| Revenues:   |         |           |             |          |          |             |   |
| Homebuilding  | \$1     | \$(54     | ) \$362,496 | \$51,121 | \$(1,248 | ) \$412,316 |   |
| Financial services                                      |         |           | 2,586       | 8,096    |          | 10,682      |   |
| Intercompany charges                                    |         | 20,207    | (25,013     | ) (877   | ) 5,683  | -           |   |
| Total revenues  | 1       | 20,153    | 340,069     | 58,340   | 4,435    | 422,998     |   |
| Expenses:   |         |           |             |          |          |             |   |
| Homebuilding  | 2,396   | 29,838    | 345,306     | 40,482   | (69      | ) 417,953   |   |
| Financial services                                      | 5       |           | 1,848       | 5,284    |          | 7,137       |   |
| Total expenses  | 2,401   | 29,838    | 347,154     | 45,766   | (69      | ) 425,090   |   |
| (Loss) income from<br>unconsolidated joint<br>ventures  |         |           | (123        | ) 950    |          | 827         |   |
| (Loss) income before<br>income taxes                    | (2,400) | (9,685    | ) (7,208    | ) 13,524 | 4,504    | (1,265      | ) |
| State and federal income<br>tax (benefit) provision     | (2,714) | )         | 131         |          |          | (2,583      | ) |
| Equity in income (loss) of<br>consolidated subsidiaries | 1,004   | (11,601   | ) 13,524    |          | (2,927   | ) -         |   |
| Net income (loss)                                       | \$1,318 | \$(21,286 | ) \$6,185   | \$13,524 | \$1,577  | \$1,318     |   |

## HOVNIANIAN ENTERPRISES, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS

SIX MONTHS ENDED APRIL 30, 2014

(In Thousands)

|   | Parent      | Subsidiary<br>Issuer | Guarantor<br>Subsidiaries | Nonguarantor<br>Subsidiaries | Eliminations | Consolidated |
|---|-------------|----------------------|---------------------------|------------------------------|--------------|--------------|
| Revenues:   |             |                      |                           |                              |              |              |
| Homebuilding  |             | \$(77 )              | \$649,190                 | \$147,358                    |              | \$796,471    |
| Financial services                                      |             |                      | 4,071                     | 13,435                       |              | 17,506       |
| Intercompany charges                                    |             | 46,555               | (48,281 )                 |                              | 1,726        | -            |
| Total revenues  | -           | 46,478               | 604,980                   | 160,793                      | 1,726        | 813,977      |
| Expenses:   |             |                      |                           |                              |              |              |
| Homebuilding  | 5,925       | 64,018               | 638,940                   | 128,138                      | (2,752 )     | 834,269      |
| Financial services                                      | 9           |                      | 3,219                     | 10,151                       |              | 13,379       |
| Total expenses  | 5,934       | 64,018               | 642,159                   | 138,289                      | (2,752 )     | 847,648      |
| Loss on extinguishment<br>of debt                       |             | (1,155 )             |                           |                              |              | (1,155 )     |
| Income from<br>unconsolidated joint<br>ventures         |             |                      | 60                        | 3,578                        |              | 3,638        |
| (Loss) income before<br>income taxes                    | (5,934 )    | (18,695 )            | (37,119 )                 | 26,082                       | 4,478        | (31,188 )    |
| State and federal income<br>tax (benefit) provision     | (5,828 )    |                      | 7,065                     |                              |              | 1,237        |
| Equity in (loss) income of<br>consolidated subsidiaries | (32,319 )   | (24,024 )            | 26,082                    |                              | 30,261       | -            |
| Net (loss) income                                       | \$(32,425 ) | \$(42,719 )          | \$(18,102 )               | \$26,082                     | \$34,739     | \$(32,425 )  |

## HOVNIANIAN ENTERPRISES, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS

SIX MONTHS ENDED APRIL 30, 2013

(In Thousands)

|  | Parent | Subsidiary<br>Issuer | Guarantor<br>Subsidiaries | Nonguarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|--------|----------------------|---------------------------|------------------------------|--------------|--------------|
|--|--------|----------------------|---------------------------|------------------------------|--------------|--------------|



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|  |           |            |             |          |          |             |   |
|--|-----------|------------|-------------|----------|----------|-------------|---|
| Revenues:  |           |            |             |          |          |             |   |
| Homebuilding   | \$3       | \$(99      | ) \$661,511 | \$99,948 | \$(2,495 | ) \$758,868 |   |
| Financial services                                   |           |            | 4,663       | 17,678   |          | 22,341      |   |
| Intercompany charges                                 |           | 40,407     | (50,334     | ) (1,751 | ) 11,678 | -           |   |
| Total revenues                                       | 3         | 40,308     | 615,840     | 115,875  | 9,183    | 781,209     |   |
| Expenses:  |           |            |             |          |          |             |   |
| Homebuilding   | 2,744     | 59,699     | 643,076     | 83,895   | 2,413    | 791,827     |   |
| Financial services                                   | 9         |            | 3,690       | 10,866   |          | 14,565      |   |
| Total expenses                                       | 2,753     | 59,699     | 646,766     | 94,761   | 2,413    | 806,392     |   |
| (Loss) gain on extinguishment of debt                |           | (770,009   | ) 770,009   |          |          | -           |   |
| Income from unconsolidated joint ventures            |           |            | 2,259       | 857      |          | 3,116       |   |
| (Loss) income before income taxes                    | (2,750    | ) (789,400 | ) 741,342   | 21,971   | 6,770    | (22,067     | ) |
| State and federal income tax (benefit) provision     | (17,075)  |            | 4,998       |          |          | (12,077     | ) |
| Equity in (loss) income of consolidated subsidiaries | (24,315)  | (22,719    | ) 21,971    |          | 25,063   | -           |   |
| Net (loss) income                                    | \$(9,990) | \$(812,119 | ) \$758,315 | \$21,971 | \$31,833 | \$(9,990    | ) |

## HOVNIANIAN ENTERPRISES, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS

SIX MONTHS ENDED APRIL 30, 2014

(In Thousands)

|   | Parent     | Subsidiary<br>Issuer | Guarantor<br>Subsidiaries | Nonguarantor<br>Subsidiaries | Eliminations | Consolidated |
|---|------------|----------------------|---------------------------|------------------------------|--------------|--------------|
| Cash flows from operating activities:   |            |                      |                           |                              |              |              |
| Net (loss) income   | \$(32,425) | \$(42,719)           | \$(18,102)                | \$26,082                     | \$34,739     | \$(32,425)   |
| Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities | (1,140)    | 9,969                | (172,179)                 | 44,408                       | (34,739)     | (153,681)    |
| Net cash (used in) provided by operating activities   | (33,565)   | (32,750)             | (190,281)                 | 70,490                       | -            | (186,106)    |
| Net cash provided by investing activities   |            | 76                   | 664                       | 4,988                        |              | 5,728        |
| Net cash provided by (used in) financing activities   |            | 120,553              | 39,646                    | (63,793)                     |              | 96,406       |
| Intercompany investing and financing activities – net   | 33,565     | (173,351)            | 151,533                   | (11,747)                     |              | -            |
| Net (decrease) increase in cash   | -          | (85,472)             | 1,562                     | (62)                         | -            | (83,972)     |
| Cash and cash equivalents balance, beginning of period  |            | 243,470              | (6,479)                   | 92,213                       |              | 329,204      |
| Cash and cash equivalents balance, end of period  | \$-        | \$157,998            | \$(4,917)                 | \$92,151                     | \$-          | \$245,232    |

## HOVNIANIAN ENTERPRISES, INC. AND SUBSIDIARIES

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS

SIX MONTHS ENDED APRIL 30, 2013

(In Thousands)

|  | Parent | Subsidiary<br>Issuer | Guarantor<br>Subsidiaries | Nonguarantor<br>Subsidiaries | Eliminations | Consolidated |
|--|--------|----------------------|---------------------------|------------------------------|--------------|--------------|
|--|--------|----------------------|---------------------------|------------------------------|--------------|--------------|

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Cash flows from operating activities:

|   |           |              |            |           |           |            |
|---|-----------|--------------|------------|-----------|-----------|------------|
| Net (loss) income   | \$(9,990) | \$(812,119 ) | \$758,315  | \$21,971  | \$31,833  | \$(9,990 ) |
| Adjustments to reconcile net (loss) income to net cash provided by (used in) operating activities | 14,384    | 773,776      | (773,952 ) | 11,695    | (31,833 ) | (5,930 )   |
| Net cash provided by (used in) operating activities   | 4,394     | (38,343 )    | (15,637 )  | 33,666    | -         | (15,920 )  |
| Net cash provided by investing activities   |           | 242          | 12,033     | 5,399     |           | 17,674     |
| Net cash (used in) provided by financing activities   |           | (2,169 )     | 20,087     | (48,042 ) |           | (30,124 )  |
| Intercompany investing and financing activities – net   | (4,394 )  | 28,338       | (17,970 )  | (5,974 )  |           | -          |
| Net decrease in cash  | -         | (11,932 )    | (1,487 )   | (14,951 ) | -         | (28,370 )  |
| Cash and cash equivalents balance, beginning of period  |           | 197,097      | (2,017 )   | 78,152    |           | 273,232    |
| Cash and cash equivalents balance, end of period  | \$-       | \$185,165    | \$(3,504 ) | \$63,201  | \$-       | \$244,862  |

#### **24. Transactions with Related Parties**

During the three months ended April 30, 2014 and 2013, an engineering firm owned by Tavit Najarian, a relative of our Chairman of the Board of Directors and Chief Executive Officer, provided services to the Company totaling \$0.2 million for both periods. During the six months ended April 30, 2014 and 2013, the services provided by such engineering firm to the Company totaled \$0.4 million for both periods. Neither the Company nor the Chairman of the Board of Directors and Chief Executive Officer has a financial interest in the relative's company from whom the services were provided.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### OVERVIEW

During the first half of fiscal 2014, the housing market has been uneven. During the period, we experienced several positive operating trends compared to the prior year. For the three and six months ended April 30, 2014, despite a reduction in the volume of deliveries, sale of homes revenues increased 7.0% and 6.7%, respectively, as compared to the same periods of the prior year. The increases in revenues were primarily due to increases in the average price per home, as a result of geographic and community mix of our deliveries, as well as price increases in certain of our communities. Also, for the three months ended April 30, 2014 compared to the three months ended April 30, 2013, we had net contract growth of 6.7% and our gross margin percentage, before cost of sales interest expense and land charges, increased from 18.9% to 20.2%. For the six months ended April 30, 2014 compared to the six months ended April 30, 2013, there were improvements in the same metrics: net contract growth of 0.4% and an increase in gross margin percentage, before cost of sales interest expense and land charges, from 18.0% to 19.5%. Active selling communities increased from 177 at April 30, 2013 to 196 at April 30, 2014. In addition, our contract cancellation rate was 17% in the second quarter of fiscal 2014, which is below what we believe to be a normalized level of approximately 20%. However, we also experienced some negative results. Net contracts per average active selling community decreased slightly to 9.3 for the three months ended April 30, 2014 compared to 9.6 in the same period in the prior year and decreased to 15.0 for the six months ended April 30, 2014 compared to 16.5 in the same period in the prior year. Selling, general and administrative costs (including corporate general and administrative expenses) as a percentage of total revenue increased from 12.2% to 13.9% for the three months ended April 30, 2014, and increased from 12.9% to 15.1% for the six months ended April 30, 2014.

When comparing sequentially from the first quarter of fiscal 2014 to the second quarter of fiscal 2014, our gross margin percentage, before cost of sales interest expense and land charges, and selling, general and administrative costs (including corporate general and administrative expenses) as a percentage of total revenues each improved. Gross margin percentage increased from 18.8% to 20.2% and selling, general and administrative costs (including corporate general and administrative expenses) as a percentage of revenues decreased from 16.6% to 13.9%, as compared to the first quarter of fiscal 2014. Cost of sales and selling, general and administrative costs include some fixed costs that are not impacted by delivery volume. Therefore, as deliveries and revenues increased from the first quarter of fiscal 2014 to the second quarter of fiscal 2014, gross margin and selling, general and administrative costs as a percentage of revenues decreased. The increase in gross margin percentage resulted primarily from a delivery volume increase in the second quarter of fiscal 2014 compared to the first quarter of fiscal 2014.

Based on the 21.0% increase in the dollar value of backlog, higher gross margin percentage and increased community count at April 30, 2014 compared to April 30, 2013, we believe that we are well-positioned for stronger results as the year progresses. However, several challenges, such as persistently high unemployment levels, national and global economic weakness and uncertainty, the restrictive mortgage lending environment, higher mortgage interest rates and the potential for more foreclosures, continue to impact the housing market and, consequently, our performance. Our

recent mixed operating results during the first half of fiscal 2014 and other national data indicate that the pace of the housing recovery has slowed. However, both national new home sales and our home sales remain below historical levels and although we continue to believe that we are still in the early stages of the housing recovery, in light of recent market trends, we currently expect uneven improvements across our operating markets.

Given the low levels of total U.S. housing starts and our belief in the long-term recovery of the homebuilding market, we remain focused on identifying new land parcels, growing our community count and growing our revenues, which are critical to improving our financial performance. We continue to see opportunities to purchase land at prices that make economic sense in light of our current sales prices and sales paces and plan to continue pursuing such land acquisitions. New land purchases at pricing that we believe will generate appropriate investment returns and drive greater operating efficiencies are needed to return to sustained profitability. During the first half of fiscal 2014, we opened for sale 55 new communities and closed 51 communities, resulting in a net increase of four communities from October 31, 2013 to 196 communities at April 30, 2014, and a net increase of three communities from 193 communities at January 31, 2014. We expect a number of new communities will open during the remainder of fiscal 2014. In addition, during the first half of fiscal 2014, we put under option or acquired 5,900 lots in 111 new communities. Homebuilding selling, general and administrative expenses increased \$10.0 million from \$37.8 million in the second quarter of fiscal 2013 to \$47.8 million for the second quarter of fiscal 2014. Approximately half of the increase was due to higher sales compensation, increased advertising costs related to an increase in community count, increased architectural expenses associated with new home designs, and a reduction of joint venture management fees, which offset general and administrative expenses, as a result of fewer joint venture deliveries. The other half of the increase was due to increased staffing levels primarily associated with the new communities and increased compensation reflective of the competitive homebuilding market. Corporate general and administrative expenses as a percentage of total revenue remained relatively flat at 3.3% in the second quarter of fiscal 2014 compared to 3.2% in the second quarter of fiscal 2013. Given the persistence of difficult market conditions, improving the efficiency of our selling, general and administrative expenses will continue to be a significant area of focus, and as we generate anticipated revenue from our increased community count, we will be able to leverage these costs.

## CRITICAL ACCOUNTING POLICIES

As disclosed in our annual report on Form 10-K for the fiscal year ended October 31, 2013, our most critical accounting policies relate to revenue recognition, inventories, land options, unconsolidated joint ventures, warranty, insurance and income taxes. Since October 31, 2013, there have been no significant changes to those critical accounting policies.

## CAPITAL RESOURCES AND LIQUIDITY

Our operations consist primarily of residential housing development and sales in the Northeast (New Jersey and Pennsylvania), the Mid-Atlantic (Delaware, Maryland, Virginia, Washington D.C. and West Virginia), the Midwest (Illinois, Minnesota and Ohio), the Southeast (Florida, Georgia, North Carolina and South Carolina), the Southwest (Arizona and Texas) and the West (California). In addition, we provide certain financial services to our homebuilding customers.

We have historically funded our homebuilding and financial services operations with cash flows from operating activities, borrowings under our bank credit facilities (when we have had such facilities for our homebuilding operations) and the issuance of new debt and equity securities. During the first half of fiscal 2014, we increased our senior unsecured notes by \$128.6 million. Despite the additional capital from the financing, our homebuilding cash balance at April 30, 2014 decreased by \$81.0 million from October 31, 2013. The significant use of cash during the first half of fiscal 2014 was primarily due to spending \$287.0 million on land and land development. The remaining change in cash came from normal operations.

Our cash uses during the six months ended April 30, 2014 and 2013 were for operating expenses, land purchases, land deposits, land development, construction spending, financing transactions, debt payments, state income taxes, interest payments and investments in joint ventures. During these periods, we provided for our cash requirements from available cash on hand, financing transactions, debt issuances, housing and land sales, model sale leasebacks, land banking deals, financial service revenues and other revenues. In June 2013, we enhanced our liquidity by entering into a \$75 million unsecured revolving credit facility, discussed below. We believe that these sources of cash will be sufficient through fiscal 2014 to finance our working capital requirements and other needs, including the ability to add new communities to grow our homebuilding operations.

Our net income (loss) historically does not approximate cash flow from operating activities. The difference between net income (loss) and cash flow from operating activities is primarily caused by changes in inventory levels together with changes in receivables, prepaid and other assets, mortgage loans held for sale, interest and other accrued liabilities, deferred income taxes, accounts payable and other liabilities, and noncash charges relating to depreciation,

amortization of computer software costs, stock compensation awards and impairment losses for inventory. When we are expanding our operations, inventory levels, prepaid expenses, and other assets increase, causing cash flow from operating activities to decrease. Certain liabilities also increase as we expand our operations and partially offset the negative effect on cash flow from operations caused by the increase in inventory levels, prepaid expenses and other assets. Similarly, as our mortgage operations expand, net income from these operations increases, but for cash flow purposes net income is offset by the net change in mortgage assets and liabilities. The opposite is true as our investment in new land purchases and development of new communities decrease, which is what happened during the last half of fiscal 2007 through fiscal 2009, allowing us to generate positive cash flow from operations during this period. Since the latter part of fiscal 2009 cumulative through April 30, 2014, as a result of the new land purchases and land development, we have used cash in operations as we add new communities. Looking forward, given the unstable housing market, it will continue to be difficult to generate positive cash flow from operations until we return to sustained profitability. However, we will continue to make adjustments to our structure and our business plans in order to maximize our liquidity while also taking steps to return to sustained profitability, including through land acquisitions.

In June 2013, K. Hovnanian Enterprises, Inc. (“K. Hovnanian”), as borrower, and we and certain of our subsidiaries, as guarantors, entered into a five-year \$75.0 million unsecured revolving credit facility (the “Credit Facility”) with Citicorp USA, Inc., as administrative agent and issuing bank, and Citibank, N.A., as a lender. The Credit Facility is available for both letters of credit and general corporate purposes. The Credit Facility does not contain any financial maintenance covenants, but does contain certain restrictive covenants that track those contained in our indenture governing the 7.0% Senior Notes due 2019, which are described in Note 11. The Credit Facility also contains certain customary events of default which would permit the administrative agent, at the request of the required lenders, to, among other things, declare all loans then outstanding to be immediately due and payable if such default is not cured within applicable grace periods, including: the failure to make timely payments of amounts payable under the Credit Facility or other material indebtedness or the acceleration of other material indebtedness, the failure to comply with agreements and covenants or for representations or warranties to be correct in all material respects when made, specified events of bankruptcy and insolvency, and the entry of a material judgment against a loan party. Outstanding borrowings under the Credit Facility accrue interest at an annual rate equal to either, as selected by K. Hovnanian, (i) the alternate base rate plus the applicable spread determined on the date of such borrowing or (ii) an adjusted LIBOR rate plus the applicable spread determined as of the date two business days prior to the first day of the interest period for such borrowing. As of April 30, 2014, there were no borrowings and \$20.0 million of letters of credit outstanding under the Credit Facility and as of such date, we believe we were in compliance with the covenants under the Credit Facility.



In addition to the Credit Facility, we have certain stand-alone cash collateralized letter of credit agreements and facilities under which there were a total of \$5.1 million of letters of credit outstanding at both April 30, 2014 and October 31, 2013. These agreements and facilities require us to maintain specified amounts of cash as collateral in segregated accounts to support the letters of credit issued thereunder, which will affect the amount of cash we have available for other uses. As of both April 30, 2014 and October 31, 2013, the amount of cash collateral in these segregated accounts was \$5.2 million, which is reflected in “Restricted cash and cash equivalents” on the Condensed Consolidated Balance Sheets.

Our wholly owned mortgage banking subsidiary, K. Hovnanian American Mortgage, LLC (“K. Hovnanian Mortgage”), originates mortgage loans primarily from the sale of our homes. Such mortgage loans and related servicing rights are sold in the secondary mortgage market within a short period of time. In certain instances, we retain the servicing rights for a small amount of loans. Our secured Master Repurchase Agreement with JPMorgan Chase Bank, N.A. (“Chase Master Repurchase Agreement”), which was amended on January 31, 2014 to extend the maturity date to January 30, 2015, is a short-term borrowing facility that provides up to \$50.0 million through maturity. The loan is secured by the mortgages held for sale and is repaid when we sell the underlying mortgage loans to permanent investors. Interest is payable monthly on outstanding advances at an adjusted LIBOR rate, which was 0.1505% at April 30, 2014, subject to a floor of 0.375%, plus the applicable margin of 2.875%. Therefore, at April 30, 2014, the interest rate was 3.25%. As of April 30, 2014 and October 31, 2013, the aggregate principal amount of all borrowings outstanding under the Chase Master Repurchase Agreement was \$11.4 million and \$33.6 million, respectively.

K. Hovnanian Mortgage has another secured Master Repurchase Agreement with Customers Bank (“Customers Master Repurchase Agreement”), which was amended on May 27, 2014 to extend the maturity date to May 26, 2015, that is a short-term borrowing facility that provides up to \$37.5 million through maturity. The loan is secured by the mortgages held for sale and is repaid when we sell the underlying mortgage loans to permanent investors. Interest is payable daily or as loans are sold to permanent investors on outstanding advances at the current LIBOR subject to a floor of 0.5% plus the applicable margin ranging from 2.75% to 5.25% based on the takeout investor, type of loan, and the number of days on the warehouse line. As of April 30, 2014 and October 31, 2013, the aggregate principal amount of all borrowings outstanding under the Customers Master Repurchase Agreement was \$9.5 million and \$30.7 million, respectively.

K. Hovnanian Mortgage has a third secured Master Repurchase Agreement with Credit Suisse First Boston Mortgage Capital LLC (“Credit Suisse Master Repurchase Agreement”), which was amended on March 28, 2014, that is a short-term borrowing facility that provides up to \$50.0 million through March 31, 2015. The loan is secured by the mortgages held for sale and is repaid when we sell the underlying mortgage loans to permanent investors. Interest is payable monthly on outstanding advances at the Credit Suisse Cost of Funds, which was 0.43% at April 30, 2014, plus the applicable margin ranging from 2.25% to 2.75% based on the takeout investor, type of loan and the number of days outstanding. As of April 30, 2014 and October 31, 2013, the aggregate principal amount of all borrowings outstanding under the Credit Suisse Master Repurchase Agreement was \$10.4 million and \$27.4 million, respectively.

In February 2014, K. Hovnanian Mortgage executed a new secured Master Repurchase Agreement with Comerica Bank (“Comerica Master Repurchase Agreement”), which was amended on March 26, 2014, that is a short-term borrowing facility that provides up to \$35.0 million through January 7, 2015. The loan is secured by the mortgages held for sale and is repaid when we sell the underlying mortgage loans to permanent investors. Interest is payable monthly at LIBOR, subject to a floor of 0.25%, plus the applicable margin of 2.625%. As of April 30, 2014, the interest rate was 2.875% and the aggregate principal amount of all borrowings outstanding under the Comerica Master Repurchase Agreement was \$4.0 million.

The Chase Master Repurchase Agreement, Customers Master Repurchase Agreement, Credit Suisse Master Repurchase Agreement and Comerica Master Repurchase Agreement (together, the “Master Repurchase Agreements”) require K. Hovnanian Mortgage to satisfy and maintain specified financial ratios and other financial condition tests. Because of the extremely short period of time mortgages are held by K. Hovnanian Mortgage before the mortgages are sold to investors (generally a period of a few weeks), the immateriality to us on a consolidated basis of the size of the Master Repurchase Agreements, the levels required by these financial covenants, our ability based on our immediately available resources to contribute sufficient capital to cure any default, were such conditions to occur, and our right to cure any conditions of default based on the terms of the agreement, we do not consider any of these covenants to be substantive or material. As of April 30, 2014, we believe we were in compliance with the covenants under the Master Repurchase Agreements.

As of April 30, 2014, we had an aggregate of \$992.0 million of outstanding senior secured notes (\$979.3 million, net of discount), an aggregate of \$591.1 million of outstanding senior notes (\$590.1 million, net of discount), \$19.0 million 11.0% Senior Amortizing Notes due 2017 (issued as a component of our 6.0% Exchangeable Note Units and discussed in Note 13) and \$68.3 million Senior Exchangeable Notes due 2017 (issued as a component of our 6.0% Exchangeable Note Units and discussed in Note 13). Except for K. Hovnanian, the issuer of the notes, our home mortgage subsidiaries, joint ventures and subsidiaries holding interests in our joint ventures, certain of our title insurance subsidiaries and our foreign subsidiary, we and each of our subsidiaries are guarantors of the senior secured, senior, senior amortizing and senior exchangeable notes outstanding at April 30, 2014 (see Note 23). In addition, the 2021 Notes (defined below) are guaranteed by K. Hovnanian JV Holdings, L.L.C. and its subsidiaries except for certain joint ventures and joint venture holding companies (collectively, the “Secured Group”). Members of the Secured Group do not guarantee K. Hovnanian's other indebtedness.

The 7.25% Senior Secured First Lien Notes due 2020 (the “First Lien Notes”) are secured by a first-priority lien and our 9.125% Senior Secured Second Lien Notes due 2020 (the “Second Lien Notes” and, together with the First Lien Notes, the “2020 Secured Notes”), are secured by a second-priority lien, in each case, subject to permitted liens and other exceptions, on substantially all the assets owned by us, K. Hovnanian and the guarantors of such notes. At April 30, 2014, the aggregate book value of the real property that constituted collateral securing the 2020 Secured Notes was approximately \$625.5 million, which does not include the impact of inventory investments, home deliveries, or impairments thereafter and which may differ from the value if it were appraised. In addition, cash and cash equivalents collateral that secured the 2020 Secured Notes was \$166.9 million as of April 30, 2014, which included \$5.2 million of restricted cash collateralizing certain letters of credit. Subsequent to such date, cash uses include general business operations and real estate and other investments.

The guarantees with respect to our 2.0% Senior Secured Notes due 2021 (the “2.0% 2021 Notes”) and 5.0% Senior Secured Notes due 2021 (the “5.0% 2021 Notes” and together with the 2.0% 2021 Notes, the “2021 Notes”) of the Secured Group are secured, subject to permitted liens and other exceptions, by a first-priority lien on substantially all of the assets of the members of the Secured Group. As of April 30, 2014, the collateral securing the guarantees included (1) \$76.3 million of cash and cash equivalents (subsequent to such date, cash uses include general business operations and real estate and other investments); (2) approximately \$119.2 million aggregate book value of real property of the Secured Group, which does not include the impact of inventory investments, home deliveries, or impairments thereafter and which may differ from the value if it were appraised, and (3) equity interests in guarantors that are members of the Secured Group. Members of the Secured Group also own equity in joint ventures, either directly or indirectly through ownership of joint venture holding companies, with a book value of \$39.3 million as of April 30, 2014; this equity is not pledged to secure, and is not collateral for, the 2021 Notes. Members of the Secured Group are “unrestricted subsidiaries” under K. Hovnanian's other senior secured notes and senior notes, and thus have not guaranteed such indebtedness.

The indentures governing our notes do not contain any financial maintenance covenants, but do contain restrictive covenants that limit, among other things, the Company’s ability and that of certain of its subsidiaries, including K. Hovnanian, to incur additional indebtedness (other than certain permitted indebtedness, refinancing indebtedness and nonrecourse indebtedness), pay dividends and make distributions on common and preferred stock, repurchase subordinated indebtedness (with respect to certain of the senior secured and senior notes), make other restricted payments, make investments, sell certain assets, incur liens, consolidate, merge, sell or otherwise dispose of all or substantially all assets and enter into certain transactions with affiliates. The indentures also contain events of default which would permit the holders of the notes to declare the notes to be immediately due and payable if not cured within applicable grace periods, including the failure to make timely payments on the notes or other material indebtedness, the failure to comply with agreements and covenants and specified events of bankruptcy and insolvency and, with respect to the indentures governing the senior secured notes, the failure of the documents granting security for the senior secured notes to be in full force and effect and the failure of the liens on any material portion of the collateral securing the senior secured notes to be valid and perfected. As of April 30, 2014, we believe we were in compliance with the covenants of the indentures governing our outstanding notes.

Under the terms of the indentures we have the right to make certain redemptions and, depending on market conditions and covenant restrictions, may do so from time to time. We also continue to evaluate our capital structure and may

also make debt purchases and/or exchanges for debt or equity from time to time through tender offers, open market purchases, private transactions, or otherwise or seek to raise additional debt or equity capital, depending on market conditions and covenant restrictions.

If our consolidated fixed charge coverage ratio, as defined in the indentures governing our senior secured and senior notes (other than the senior exchangeable notes discussed in Note 13 to the Condensed Consolidated Financial Statements), is less than 2.0 to 1.0, we are restricted from making certain payments, including dividends, and from incurring indebtedness other than certain permitted indebtedness, refinancing indebtedness and nonrecourse indebtedness. As a result of this restriction, we are currently restricted from paying dividends, which are not cumulative, on our 7.625% Series A Preferred Stock. We anticipate we will continue to be restricted from paying dividends for the foreseeable future. Our inability to pay dividends is in accordance with covenant restrictions and will not result in a default under our bond indentures or otherwise affect compliance with any of the covenants contained in the bond indentures.

On January 10, 2014, K. Hovnanian issued \$150.0 million aggregate principal amount of 7.0% Senior Notes due 2019, resulting in net proceeds of approximately \$147.8 million. The notes are redeemable in whole or in part at our option at any time prior to July 15, 2016 at 100% of their principal amount plus an applicable "Make-Whole Amount." We may also redeem some or all of the notes at 103.5% of principal commencing July 15, 2016, at 101.75% of principal commencing January 15, 2017 and 100% of principal commencing January 15, 2018. In addition, we may redeem up to 35% of the aggregate principal amount of the notes prior to July 15, 2016 with the net cash proceeds from certain equity offerings at 107.0% of principal. We used a portion of the net proceeds to fund the redemption on February 9, 2014 (effected on February 10, 2014 which was the next business day after the redemption date) of the remaining outstanding principal amount (\$21.4 million) of our 6.25% Senior Notes due 2015. The redemption resulted in a loss on extinguishment of debt of \$1.2 million, net of the write-off of unamortized fees, and is included in the Condensed Consolidated Statement of Operations as "Loss on extinguishment of debt" for three and six months ended April 30, 2014. The remaining net proceeds from the offering were used to pay related fees and expenses and for corporate general purposes.

February 15, 2014 was the mandatory settlement date for our Purchase Contracts and was also the payment date for the last quarterly cash installment payment on the Senior Subordinated Amortizing Notes, both of which were initially issued as components of our 7.25% Tangible Equity Units. See Note 12 to the Condensed Consolidated Financial Statements for additional information.

Total inventory, excluding consolidated inventory not owned, increased \$209.8 million during the six months ended April 30, 2014. Total inventory, excluding consolidated inventory not owned, increased in the Mid-Atlantic by \$39.0 million, in the Midwest by \$25.5 million, in the Southeast by \$24.2 million, in the Southwest by \$101.2 million and in the West by \$26.3 million. This increase was partially offset by a decrease in the Northeast of \$6.4 million. The increases were primarily attributable to new land purchases and land development during the period, offset by home deliveries. The decrease in the Northeast during the first half of fiscal 2014 was due to delivering homes at a faster pace than purchasing new land to replenish our inventory. During the six months ended April 30, 2014, we incurred \$0.1 million in impairments in the Northeast. In addition, we wrote-off costs in the amount of \$1.1 million during the six months ended April 30, 2014 related to land options that expired or that we terminated, as the communities' forecasted profitability was not projected to produce adequate returns on investment commensurate with the risk. In the last few years, we have been able to acquire new land parcels at prices that we believe will generate reasonable returns under current homebuilding market conditions. There can be no assurances that this trend will continue in the near term. Substantially all homes under construction or completed and included in inventory at April 30, 2014 are expected to be closed during the next 12 months.

The total inventory increase discussed above excluded the increase in consolidated inventory not owned of \$7.1 million. Consolidated inventory not owned consists of specific performance options and other options that were added to our Condensed Consolidated Balance Sheet in accordance with GAAP. The increase from October 31, 2013 to April 30, 2014 was primarily due to an increase in the sale and leaseback of certain model homes during the first half of fiscal 2014, partially offset by a decrease in land banking transactions. We sell and lease back certain of our model homes with the right to participate in the potential profit when each home is sold to a third party at the end of the respective lease. As a result of our continued involvement for accounting purposes in accordance with ASC 360-20-40-38, these sale and leaseback transactions are considered a financing rather than a sale for accounting purposes. Therefore, for purposes of our Condensed Consolidated Balance Sheet, at April 30, 2014, inventory of \$69.3 million was recorded to "Consolidated inventory not owned - other options," with a corresponding amount of \$65.3 million recorded to "Liabilities from inventory not owned." In addition, we have land banking arrangements whereby we sell land parcels to the land bankers and they provide us an option to purchase back finished lots on a quarterly basis. Because of our options to repurchase these parcels, for accounting purposes in accordance with ASC 360-20-40-38, these transactions are considered a financing rather than a sale. For purposes of our Condensed Consolidated Balance Sheet, at April 30, 2014, inventory of \$36.5 million was recorded to "Consolidated inventory not owned - other options," with a corresponding amount of \$27.6 million recorded to "Liabilities from inventory not owned" for the amount of net cash received from the transactions. From time to time, we enter into option agreements that include specific performance requirements, whereby we are required to purchase a minimum number of lots. Because of our obligation to purchase these lots, for accounting purposes in accordance with ASC 360-20-40-38, we are required to record this inventory on our Condensed Consolidated Balance Sheets. As of April 30, 2014, we had \$2.2 million of specific performance options recorded on our Condensed Consolidated Balance Sheets to "Consolidated inventory not owned - specific performance options," with a corresponding liability of \$2.0 million recorded to "Liabilities from inventory not owned."

When possible, we option property for development prior to acquisition. By optioning property, we are only subject to the loss of the cost of the option and predevelopment costs if we choose not to exercise the option (other than with respect to specific performance options discussed above). As a result, our commitment for major land acquisitions is reduced. The costs associated with optioned properties are included in "Land and land options held for future development or sale" on the Condensed Consolidated Balance Sheets. Also included in "Land and land options held for future development or sale" are amounts associated with inventory in mothballed communities. We mothball (or stop development on) certain communities when we determine the current performance does not justify further investment at the time. That is, we believe we will generate higher returns if we decide against spending money to improve land today and save the raw land until such times as the markets improve or we determine to sell the property. As of April 30, 2014, we have mothballed land in 47 communities. The book value associated with these communities at April 30, 2014 was \$106.2 million, net of impairment charges recorded in prior periods of \$419.2 million. We continually review communities to determine if mothballing is appropriate. During the first half of fiscal 2014, we did not mothball any new communities, and sold one community which was previously mothballed. In addition, two communities which were previously mothballed were re-activated during the second quarter of fiscal 2014. Our inventory representing "Land and land options held for future development or sale" at April 30, 2014, on the Condensed Consolidated Balance Sheets, increased by \$11.6 million compared to October 31, 2013. The increase was primarily due to the acquisition of new land in all segments during the first half of fiscal 2014, offset by the movement of certain of our communities from held for future development to sold and unsold homes and lots under development during the period, combined with land sales in the Northeast, Southeast and Southwest.

Inventories held for sale, which are land parcels where we have decided not to build homes, represented \$1.7 million of our total inventories at April 30, 2014, and are reported at the lower of carrying amount or fair value less costs to sell. In determining fair value for land held for sale, management considers, among other things, prices for land in recent comparable sale transactions, market analysis studies, which include the estimated price a willing buyer would pay for the land (other than in a forced liquidation sale) and recent bona fide offers received from outside third parties.

The following table summarizes home sites included in our total residential real estate. The increase in total home sites available at April 30, 2014 compared to October 31, 2013 is attributable to signing new land option agreements and acquiring new land parcels, offset by terminating certain option agreements and delivering homes.

|   | Active<br>Communities(1) | Active Communities<br>Homes | Proposed Developable<br>Homes | Total<br>Homes |
|---|--------------------------|-----------------------------|-------------------------------|----------------|
| April 30, 2014:                                     |                          |                             |                               |                |
| Northeast   | 11                       | 1,296                       | 3,624                         | 4,920          |
| Mid-Atlantic  | 36                       | 2,898                       | 3,557                         | 6,455          |
| Midwest   | 33                       | 3,282                       | 1,899                         | 5,181          |
| Southeast   | 18                       | 1,572                       | 3,968                         | 5,540          |
| Southwest   | 88                       | 5,500                       | 1,818                         | 7,318          |
| West  | 10                       | 1,368                       | 4,746                         | 6,114          |
| Consolidated total                                  | 196                      | 15,916                      | 19,612                        | 35,528         |
| Unconsolidated joint ventures                       | 7                        | 1,642                       | 905                           | 2,547          |
| Total including unconsolidated<br>joint ventures    | 203                      | 17,558                      | 20,517                        | 38,075         |
| Owned   |                          | 9,559                       | 8,761                         | 18,320         |
| Optioned  |                          | 6,069                       | 10,851                        | 16,920         |
| Controlled lots                                     |                          | 15,628                      | 19,612                        | 35,240         |
| Construction to permanent<br>financing lots         |                          | 288                         | -                             | 288            |
| Consolidated total                                  |                          | 15,916                      | 19,612                        | 35,528         |
| Lots controlled by unconsolidated<br>joint ventures |                          | 1,642                       | 905                           | 2,547          |
| Total including unconsolidated<br>joint ventures    |                          | 17,558                      | 20,517                        | 38,075         |

(1) Active communities are open for sale communities with 10 or more home sites available.



|  | Active Communities(1) | Active Communities Homes | Proposed Developable Homes | Total Homes |
|--|-----------------------|--------------------------|----------------------------|-------------|
| October 31, 2013:                                |                       |                          |                            |             |
| Northeast  | 12                    | 1,142                    | 3,626                      | 4,768       |
| Mid-Atlantic                                     | 29                    | 2,645                    | 2,953                      | 5,598       |
| Midwest  | 27                    | 3,083                    | 1,709                      | 4,792       |
| Southeast  | 24                    | 1,257                    | 2,578                      | 3,835       |
| Southwest  | 88                    | 4,945                    | 2,115                      | 7,060       |
| West   | 12                    | 1,410                    | 4,634                      | 6,044       |
| Consolidated total                               | 192                   | 14,482                   | 17,615                     | 32,097      |
| Unconsolidated joint ventures                    | 10                    | 1,864                    | 749                        | 2,613       |
| Total including unconsolidated joint ventures    | 202                   | 16,346                   | 18,364                     | 34,710      |
| Owned  |                       | 7,470                    | 8,856                      | 16,326      |
| Optioned   |                       | 6,764                    | 8,759                      | 15,523      |
| Controlled lots                                  |                       | 14,234                   | 17,615                     | 31,849      |
| Construction to permanent financing lots         |                       | 248                      | -                          | 248         |
| Consolidated total                               |                       | 14,482                   | 17,615                     | 32,097      |
| Lots controlled by unconsolidated joint ventures |                       | 1,864                    | 749                        | 2,613       |
| Total including unconsolidated joint ventures    |                       | 16,346                   | 18,364                     | 34,710      |

(1) Active communities are open for sale communities with 10 or more home sites available.

The following table summarizes our started or completed unsold homes and models, excluding unconsolidated joint ventures, in active and substantially completed communities. The increase from October 31, 2013 to April 30, 2014 is due to a focused effort to improve top line revenue growth by increasing our number of started unsold homes available for expedited delivery.

|   | April 30, 2014 |        |       | October 31, 2013 |        |       |
|---|----------------|--------|-------|------------------|--------|-------|
|   | Unsold Homes   | Models | Total | Unsold Homes     | Models | Total |
| Northeast   | 94             | 10     | 104   | 95               | 14     | 109   |
| Mid-Atlantic  | 99             | 2      | 101   | 78               | 9      | 87    |
| Midwest   | 12             | 4      | 16    | 17               | 8      | 25    |
| Southeast   | 72             | 15     | 87    | 57               | 9      | 66    |
| Southwest   | 335            | 5      | 340   | 346              | 13     | 359   |
| West  | 57             | 8      | 65    | 40               | 8      | 48    |
| Total   | 669            | 44     | 713   | 633              | 61     | 694   |
| Started or completed unsold homes and models per active selling communities (1) | 3.4            | 0.2    | 3.6   | 3.3              | 0.3    | 3.6   |

Active selling communities (which are communities that are open for sale with 10 or more home sites available) (1) were 196 and 192 at April 30, 2014 and October 31, 2013, respectively. Ratio does not include substantially completed communities, which are communities with less than 10 home sites available.

Investments in and advances to unconsolidated joint ventures decreased \$3.8 million to \$47.7 million at April 30, 2014 compared to October 31, 2013. The decrease was primarily due to a partnership distribution received during the period, along with the timing of advances at April 30, 2014 as compared to October 31, 2013. As of April 30, 2014, we had investments in seven homebuilding joint ventures and one land development joint venture. We have no guarantees associated with our unconsolidated joint ventures, other than guarantees limited only to performance and completion of development, environmental indemnification and standard warranty and representation against fraud misrepresentation and similar actions, including a voluntary bankruptcy.

Receivables, deposits and notes increased \$7.7 million from October 31, 2013 to \$52.8 million at April 30, 2014. The increase was primarily due to an increase in receivables for home closings as a result of cash in transit from various title companies at the end of the respective periods, along with new receivables from our insurance carriers for certain warranty claims. Offsetting these increases were decreases for certain notes receivable collected during the first half of fiscal 2014.

Prepaid expenses and other assets were as follows as of:

| (In thousands)        | April 30,<br>2014 | October 31,<br>2013 | Dollar<br>Change |
|-----------------------|-------------------|---------------------|------------------|
| Prepaid insurance     | \$1,669           | \$3,213             | \$(1,544)        |
| Prepaid project costs | 28,964            | 23,841              | 5,123            |
| Net rental properties | 1,638             | 1,975               | (337 )           |
| Other prepaids        | 30,233            | 30,055              | 178              |
| Other assets          | 152               | 267                 | (115 )           |
| Total                 | \$62,656          | \$59,351            | \$3,305          |

Prepaid insurance decreased \$1.5 million during the six months ended April 30, 2014 due to the timing of premium payments. These costs are amortized over the life of the associated insurance policy, which can be one to three years. Prepaid project costs consist of community specific expenditures that are used over the life of the community. Such prepaids are expensed as homes are delivered. The increase of \$5.1 million from October 31, 2013 to April 30, 2014 is associated with the opening of 55 new communities during the first half of fiscal 2014.

Financial Services - Restricted cash and cash equivalents decreased \$4.3 million to \$17.3 million at April 30, 2014. The decrease was primarily related to a decrease in the volume and timing of home closings at the end of the second quarter of fiscal 2014 compared to the end of fiscal 2013.

Financial Services - Mortgage loans held for sale consist primarily of residential mortgages receivable held for sale of which \$55.1 million and \$109.7 million at April 30, 2014 and October 31, 2013, respectively, were being temporarily warehoused and are awaiting sale in the secondary mortgage market. The decrease in mortgage loans held for sale from October 31, 2013 is related to a decrease in the volume of loans originated during the second quarter of 2014 compared to the fourth quarter of 2013, partially offset by a slight increase in the average loan value.

Financial Services – Other assets decreased \$2.0 million to \$2.2 million at April 30, 2014. The decrease is related to the closing of mortgages in November 2013, which were funded in the fourth quarter of fiscal 2013.

Nonrecourse mortgages increased to \$92.9 million at April 30, 2014 from \$62.9 million at October 31, 2013. The increase was primarily due to new mortgages for communities across all homebuilding segments obtained during the six months ended April 30, 2014.

Accounts payable and other liabilities are as follows as of:

| (In thousands)       | April 30,<br>2014 | October 31,<br>2013 | Dollar<br>Change |
|----------------------|-------------------|---------------------|------------------|
| Accounts payable     | \$112,897         | \$98,585            | \$14,312         |
| Reserves             | 139,758           | 136,029             | 3,729            |
| Accrued expenses     | 17,075            | 26,454              | (9,379 )         |
| Accrued compensation | 27,064            | 39,704              | (12,640 )        |
| Other liabilities    | 6,538             | 6,992               | (454 )           |
| Total                | \$303,332         | \$307,764           | \$(4,432 )       |

The increase in accounts payable was primarily related to the timing of invoices and payments in the second quarter of fiscal 2014 compared to the fourth quarter of fiscal 2013, due to an increase in construction spending during the period, which correlates to the increase in backlog from October 31, 2013 to April 30, 2014. Reserves increased during the period as new accruals for general liability insurance exceeded payments for warranty related claims. The decrease in accrued expenses is primarily due to decreases in accrued property tax and amortization of accruals related to abandoned lease space. The decrease in accrued compensation is primarily due to the payment of our fiscal year 2013 bonuses during the first quarter of 2014, partially offset by six months of the fiscal 2014 bonus accrual.

Customers' deposits increased \$8.2 million to \$38.3 million at April 30, 2014. The increase is primarily related to the increase in backlog during the period.

Liabilities from inventory not owned increased \$7.0 million to \$94.9 at April 30, 2014. The increase is primarily due to an increase in the sale and leaseback of certain model homes and specific performance transactions, partially offset by a decrease in land banking transactions during the period as described above.

Financial Services - Accounts payable and other liabilities decreased \$5.9 million to \$27.0 million at April 30, 2014. The decrease is primarily related to the decrease in Financial Services restricted cash during the period, due to a decrease in the volume and timing of home closings during the second quarter of fiscal 2014 compared to the fourth quarter of fiscal 2013.

Financial Services - Mortgage warehouse lines of credit decreased \$56.4 million from \$91.7 million at October 31, 2013, to \$35.3 million at April 30, 2014. The decrease correlates to the decrease in the volume of mortgage loans held for sale during the period.

Accrued Interest increased \$4.0 million to \$32.3 million at April 30, 2014. This increase is due to the timing of semi-annual interest payments on our bonds.

## RESULTS OF OPERATIONS FOR THE THREE AND SIX MONTHS ENDED APRIL 30, 2014 COMPARED TO THE THREE AND SIX MONTHS ENDED APRIL 30, 2013

## Total revenues

Compared to the same prior period, revenues increased (decreased) as follows:

| (Dollars in thousands)        | Three Months Ended |                | Dollar Change | Percentage Change |    |
|-------------------------------|--------------------|----------------|---------------|-------------------|----|
|                               | April 30, 2014     | April 30, 2013 |               |                   |    |
| Homebuilding:                 |                    |                |               |                   |    |
| Sale of homes                 | \$438,302          | \$409,576      | \$28,726      | 7.0               | %  |
| Land sales and other revenues | 2,215              | 2,740          | (525)         | (19.2)            | )% |
| Financial services            | 9,412              | 10,682         | (1,270)       | (11.9)            | )% |
| Total revenues                | \$449,929          | \$422,998      | \$26,931      | 6.4               | %  |

| (Dollars in thousands)        | Six Months Ended |                | Dollar Change | Percentage Change |    |
|-------------------------------|------------------|----------------|---------------|-------------------|----|
|                               | April 30, 2014   | April 30, 2013 |               |                   |    |
| Homebuilding:                 |                  |                |               |                   |    |
| Sale of homes                 | \$793,483        | \$743,857      | \$49,626      | 6.7               | %  |
| Land sales and other revenues | 2,988            | 15,011         | (12,023)      | (80.1)            | )% |
| Financial services            | 17,506           | 22,341         | (4,835)       | (21.6)            | )% |
| Total revenues                | \$813,977        | \$781,209      | \$32,768      | 4.2               | %  |

## Homebuilding

For the three and six months ended April 30, 2014, sale of homes revenues increased \$28.7 million, or 7.0%, and \$49.6 million or 6.7%, respectively, as compared to the same period of the prior year. These increases were primarily due to the 8.7% and 8.8% increases in the average price per home, slightly offset by the number of home deliveries decreasing 1.6% and 2.0% for the three and six months ended April 30, 2014, compared to the three and six months ended April 30, 2013, respectively. The average price per home increased to \$355,000 in the three months ended April 30, 2014 from \$326,000 in the three months ended April 30, 2013. The average price per home increased to \$349,000 in the six months ended April 30, 2014 from \$321,000 in the six months ended April 30, 2013. The fluctuations in

average prices were a result of geographic and community mix of our deliveries, as well as price increases in certain of our individual communities. During fiscal 2013 we were able to raise prices in a number of our communities. However, in fiscal 2014 our ability to raise prices has been limited as the sales pace per community slowed, and in some communities, we have recently lowered prices or increased incentives. Land sales are ancillary to our homebuilding operations and are expected to continue in the future but may significantly fluctuate up or down. For further details on the increase in land sales and other revenues, see the section titled "Land Sales and Other Revenues" below.

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Information on homes delivered by segment is set forth below:

| (Dollars in thousands)        | Three Months Ended April 30, |           |          | Six Months Ended April 30, |           |           |        |    |
|-------------------------------|------------------------------|-----------|----------|----------------------------|-----------|-----------|--------|----|
|                               | 2014                         | 2013      | % Change | 2014                       | 2013      | % Change  |        |    |
| Northeast:                    |                              |           |          |                            |           |           |        |    |
| Dollars                       | \$65,550                     | \$53,099  | 23.4     | %                          | \$118,683 | \$107,333 | 10.6   | %  |
| Homes                         | 134                          | 113       | 18.6     | %                          | 240       | 237       | 1.3    | %  |
| Mid-Atlantic:                 |                              |           |          |                            |           |           |        |    |
| Dollars                       | \$68,431                     | \$57,706  | 18.6     | %                          | \$128,781 | \$110,152 | 16.9   | %  |
| Homes                         | 145                          | 135       | 7.4      | %                          | 270       | 252       | 7.1    | %  |
| Midwest:                      |                              |           |          |                            |           |           |        |    |
| Dollars                       | \$48,624                     | \$39,356  | 23.5     | %                          | \$92,363  | \$71,528  | 29.1   | %  |
| Homes                         | 167                          | 159       | 5.0      | %                          | 336       | 297       | 13.1   | %  |
| Southeast:                    |                              |           |          |                            |           |           |        |    |
| Dollars                       | \$50,792                     | \$37,119  | 36.8     | %                          | \$89,920  | \$65,723  | 36.8   | %  |
| Homes                         | 164                          | 135       | 21.5     | %                          | 295       | 244       | 20.9   | %  |
| Southwest:                    |                              |           |          |                            |           |           |        |    |
| Dollars                       | \$164,212                    | \$160,988 | 2.0      | %                          | \$292,297 | \$281,717 | 3.8    | %  |
| Homes                         | 551                          | 571       | (3.5)    | )%                         | 992       | 1,019     | (2.6)  | )% |
| West:                         |                              |           |          |                            |           |           |        |    |
| Dollars                       | \$40,693                     | \$61,308  | (33.6)   | )%                         | \$71,439  | \$107,404 | (33.5) | )% |
| Homes                         | 74                           | 142       | (47.9)   | )%                         | 138       | 268       | (48.5) | )% |
| Consolidated total:           |                              |           |          |                            |           |           |        |    |
| Dollars                       | \$438,302                    | \$409,576 | 7.0      | %                          | \$793,483 | \$743,857 | 6.7    | %  |
| Homes                         | 1,235                        | 1,255     | (1.6)    | )%                         | 2,271     | 2,317     | (2.0)  | )% |
| Unconsolidated joint ventures |                              |           |          |                            |           |           |        |    |
| Dollars                       | \$33,411                     | \$74,119  | (54.9)   | )%                         | \$77,987  | \$133,113 | (41.4) | )% |
| Homes                         | 96                           | 169       | (43.2)   | )%                         | 198       | 295       | (32.9) | )% |
| Totals:                       |                              |           |          |                            |           |           |        |    |
| Dollars                       | \$471,713                    | \$483,695 | (2.5)    | )%                         | \$871,470 | \$876,970 | (0.6)  | )% |
| Homes                         | 1,331                        | 1,424     | (6.5)    | )%                         | 2,469     | 2,612     | (5.5)  | )% |

As discussed above, the overall increase in housing revenues during the three and six months ended April 30, 2014 as compared to the same period of the prior year was attributed to an increase in average sales price, as the number of



deliveries declined.

46

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An important indicator of our future results are recently signed contracts and our home contract backlog for future deliveries. Our sales contracts and homes in contract backlog by segment are set forth below:

| (Dollars in thousands) | Net Contracts (1) for<br>the    |          | Net Contracts (1) for<br>the  |           | Contract Backlog as<br>of |           |
|------------------------|---------------------------------|----------|-------------------------------|-----------|---------------------------|-----------|
|                        | Three Months Ended<br>April 30, |          | Six Months Ended<br>April 30, |           | April 30,                 |           |
|                        | 2014                            | 2013     | 2014                          | 2013      | 2014                      | 2013      |
| Northeast:             |                                 |          |                               |           |                           |           |
| Dollars                | \$75,485                        | \$86,311 | \$127,523                     | \$131,667 | \$113,846                 | \$139,750 |
| Homes                  | 156                             | 183      | 257                           | 288       | 237                       | 315       |
| Mid-Atlantic:          |                                 |          |                               |           |                           |           |
| Dollars                | \$119,935                       | \$89,896 | \$190,832                     | \$159,818 | \$203,218                 | \$168,438 |
| Homes                  | 263                             | 181      | 403                           | 327       | 404                       | 341       |
| Midwest:               |                                 |          |                               |           |                           |           |
| Dollars                | \$65,242                        | \$60,898 | \$113,633                     | \$100,885 | \$171,987                 | \$125,073 |
| Homes                  | 229                             | 247      | 397                           | 400       | 666                       | 530       |