

Meritage Homes CORP  
Form 10-Q/A  
February 22, 2005

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q/A**

(Amendment No. 1)

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

**For the quarterly period ended June 30, 2004**

Or

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

**Commission File Number 1-9977**

**MERITAGE HOMES CORPORATION**

(Exact Name of Registrant as Specified in Its Charter)

**Maryland**  
(State or Other Jurisdiction  
of Incorporation or Organization)

**8501 E. Princess Drive, Suite 290**  
**Scottsdale, Arizona**  
(Address of Principal Executive Offices)

**86-0611231**  
(I.R.S. Employer  
Identification No.)

**85255**  
(Zip Code)

**(480) 609-3330**  
(Registrant's Telephone Number, Including Area Code)

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

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

Common shares outstanding as of July 28, 2004: 12,961,027.

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**MERITAGE HOMES CORPORATION**

**FORM 10-Q/A FOR THE QUARTER ENDED JUNE 30, 2004**

**Explanatory Note**

This Amendment No. 1 on Form 10-Q/A to Form 10-Q of Meritage Homes Corporation, for the quarter ended June 30, 2004 reflects restatements to certain historical financial data and related descriptions as originally filed. This restatement includes changes to Part I, Items 1, 2 and 4 and relates to our model home lease program. See Note 10 to our Unaudited Condensed Consolidated Financial Statements for further discussion of this matter.

Except for the accounts, data and descriptions relating to our model home lease program, no other information in this report is being changed. This report continues to speak as of the date of the original filing, and we have not updated the disclosures in this report to speak as of a later date. We are not required to and we have not updated any forward-looking statements previously included in the Form 10-Q filed on August 5, 2004.

**TABLE OF CONTENTS**

|                        |   |
|------------------------|---|
| <b><u>PART I.</u></b>  | <b><u>FINANCIAL INFORMATION</u></b>   |
| <b><u>Item 1.</u></b>  | <b><u>Financial Statements:</u></b>   |
|                        | <u>Unaudited Condensed Consolidated Balance Sheets as of June 30, 2004 (Restated) and December 31, 2003</u>                         |
|                        | <u>Unaudited Condensed Consolidated Statements of Earnings for the Three and Six Months ended June 30, 2004 (Restated) and 2003</u> |
|                        | <u>Unaudited Condensed Consolidated Statements of Cash Flows for the Six Months ended June 30, 2004 (Restated) and 2003</u>         |
|                        | <u>Notes to Unaudited Condensed Consolidated Financial Statements</u>   |
| <b><u>Item 2.</u></b>  | <b><u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>                                 |
| <b><u>Item 3.</u></b>  | <b><u>Quantitative and Qualitative Disclosures About Market Risk</u></b>  |
| <b><u>Item 4.</u></b>  | <b><u>Controls and Procedures</u></b>   |
| <b><u>PART II.</u></b> | <b><u>OTHER INFORMATION</u></b>   |
| <b><u>Item 1.</u></b>  | <b><u>Not Applicable</u></b>  |
| <b><u>Item 2.</u></b>  | <b><u>Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities</u></b>                                      |
| <b><u>Item 3.</u></b>  | <b><u>Not Applicable</u></b>  |

**Item 4.**                    **Submission of Matters to a Vote of Security Holders**

**Item 5.**                    **Not Applicable**

**Item 6.**                    **Exhibits and Reports on Form 8-K**

**SIGNATURES**

**PART I FINANCIAL INFORMATION****Item 1. Financial Statements****MERITAGE HOMES CORPORATION AND SUBSIDIARIES****UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except share amounts)

|  | <b>June 30,<br/>2004</b>              | <b>December 31,<br/>2003</b> |
|--|---------------------------------------|------------------------------|
|  | <b>(As Restated,<br/>See Note 10)</b> |                              |
| <b>Assets</b>  |                                       |                              |
| Cash and cash equivalents  | \$ 11,735                             | \$ 4,799                     |
| Real estate  | 780,176                               | 678,011                      |
| Consolidated real estate not owned   | 28,336                                | 18,572                       |
| Deposits on real estate under option or contract   | 118,019                               | 105,870                      |
| Investments in unconsolidated entities   | 33,974                                | 23,528                       |
| Receivables, net   | 9,014                                 | 8,716                        |
| Deferred tax asset, net  | 1,443                                 | 1,204                        |
| Goodwill   | 88,664                                | 75,645                       |
| Property and equipment, net  | 27,495                                | 23,669                       |
| Prepaid expenses and other assets  | 14,468                                | 14,525                       |
| <b>Total assets</b>  | <b>\$ 1,113,324</b>                   | <b>\$ 954,539</b>            |
| <b>Liabilities</b>   |                                       |                              |
| Accounts payable   | \$ 75,628                             | \$ 80,737                    |
| Accrued liabilities  | 63,032                                | 67,411                       |
| Home sale deposits   | 38,452                                | 25,352                       |
| Obligations related to consolidated real estate not owned  | 21,839                                | 17,653                       |
| Senior notes   | 417,539                               | 287,991                      |
| Loans payable and other borrowings   | 49,396                                | 63,500                       |
| <b>Total liabilities</b>   | <b>665,886</b>                        | <b>542,644</b>               |
| <b>Commitments and Contingencies (Notes 3, 4, and 5)</b>   |                                       |                              |
| <b>Stockholders Equity</b>   |                                       |                              |
| Common stock, par value \$0.01. 50,000,000 shares authorized; 15,639,273 and 15,479,558 shares issued at June 30, 2004 and December 31, 2003, respectively | 156                                   | 155                          |
| Additional paid-in capital   | 206,518                               | 202,678                      |
| Retained earnings  | 294,170                               | 242,615                      |
| Treasury stock at cost, 2,602,226 and 2,302,226 shares at June 30, 2004 and December 31, 2003, respectively  | (53,406)                              | (33,553)                     |
| <b>Total stockholders equity</b>   | <b>447,438</b>                        | <b>411,895</b>               |

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|   |    |           |    |         |
|---|----|-----------|----|---------|
| Total liabilities and stockholders equity | \$ | 1,113,324 | \$ | 954,539 |
|---|----|-----------|----|---------|

See accompanying notes to condensed consolidated financial statements

## MERITAGE HOMES CORPORATION AND SUBSIDIARIES

## UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

(in thousands, except per share amounts)

|  | Three Months Ended June 30,           |            | Six Months Ended June 30,             |            |
|--|---------------------------------------|------------|---------------------------------------|------------|
|  | 2004<br>(As Restated,<br>See Note 10) | 2003       | 2004<br>(As Restated,<br>See Note 10) | 2003       |
| Home closing revenue                       | \$ 431,275                            | \$ 325,733 | \$ 854,777                            | \$ 609,143 |
| Land closing revenue                       | 2,660                                 | 8,100      | 2,660                                 | 8,100      |
|  | 433,935                               | 333,833    | 857,437                               | 617,243    |
| Cost of home closings                      | (352,568)                             | (260,369)  | (692,907)                             | (487,425)  |
| Cost of land closings                      | (1,731)                               | (6,859)    | (1,731)                               | (6,859)    |
|  | (354,299)                             | (267,228)  | (694,638)                             | (494,284)  |
| Home closing gross profit                  | 78,707                                | 65,364     | 161,870                               | 121,718    |
| Land closing gross profit                  | 929                                   | 1,241      | 929                                   | 1,241      |
|  | 79,636                                | 66,605     | 162,799                               | 122,959    |
| Commissions and other sales costs          | (25,996)                              | (21,328)   | (51,829)                              | (41,073)   |
| General and administrative costs           | (16,794)                              | (12,076)   | (32,850)                              | (24,288)   |
| Other income, net                          | 2,980                                 | 863        | 5,169                                 | 2,072      |
| Earnings before provision for income taxes | 39,826                                | 34,064     | 83,289                                | 59,670     |
| Provision for income taxes                 | (15,189)                              | (12,752)   | (31,733)                              | (22,585)   |
| Net earnings                               | \$ 24,637                             | \$ 21,312  | \$ 51,556                             | \$ 37,085  |
| Weighted average number of shares:         |                                       |            |                                       |            |
| Basic                                      | 13,146                                | 12,985     | 13,190                                | 13,013     |
| Diluted                                    | 13,912                                | 13,747     | 13,982                                | 13,715     |
| Net earnings per common share:             |                                       |            |                                       |            |
| Basic                                      | \$ 1.87                               | \$ 1.64    | \$ 3.91                               | \$ 2.85    |
| Diluted                                    | \$ 1.77                               | \$ 1.55    | \$ 3.69                               | \$ 2.70    |

See accompanying notes to condensed consolidated financial statements

## MERITAGE HOMES CORPORATION AND SUBSIDIARIES

## UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

|   | Six Months Ended June 30,     |           |
|---|-------------------------------|-----------|
|   | 2004                          | 2003      |
|   | (As Restated,<br>See Note 10) |           |
| <b>Cash flows from operating activities:</b>                                    |                               |           |
| Net earnings  | \$ 51,556                     | \$ 37,085 |
| Adjustments to reconcile net earnings to net cash used in operating activities: |                               |           |
| Depreciation and amortization   | 5,764                         | 3,746     |
| Deferred income tax provision   | (239)                         | (90)      |
| Tax benefit from stock option exercises   | 1,701                         |           |
| Equity in earnings from unconsolidated entities                                 | (1,491)                       | (1,063)   |
| Net increase in assets not owned  | (5,578)                       | (1,445)   |
| Changes in assets and liabilities, net of effect of acquisition:                |                               |           |
| Increase in real estate   | (65,584)                      | (126,348) |
| Increase in deposits on real estate under option or contract                    | (10,279)                      | (13,025)  |
| (Increase) decrease in receivables and prepaid expenses and other assets        | (339)                         | 2,928     |
| (Decrease) increase in accounts payable and accrued liabilities                 | (11,193)                      | 17,532    |
| Increase in home sale deposits  | 13,013                        | 8,784     |
| Net cash used in operating activities   | (22,669)                      | (71,896)  |
| <b>Cash flows from investing activities:</b>                                    |                               |           |
| Investments in unconsolidated entities  | (10,929)                      | (5,816)   |
| Distributions from unconsolidated entities                                      | 1,975                         | 1,174     |
| Cash paid for acquisition   | (24,165)                      |           |
| Purchases of property and equipment   | (8,648)                       | (5,385)   |
| Increase in goodwill  | (1,805)                       | (723)     |
| Net cash used in investing activities   | (43,572)                      | (10,750)  |
| <b>Cash flows from financing activities:</b>                                    |                               |           |
| Proceeds from loans payable   | 776,000                       | 519,535   |
| Repayments of loans payable   | (815,100)                     | (464,212) |
| Proceeds from issuance of senior notes  | 130,000                       | 51,625    |
| Purchase of treasury stock  | (19,853)                      | (5,180)   |
| Proceeds from stock option exercises  | 2,130                         | 833       |
| Net cash provided by financing activities                                       | 73,177                        | 102,601   |
| Net increase in cash and cash equivalents                                       | 6,936                         | 19,955    |
| Cash and cash equivalents at beginning of period                                | 4,799                         | 6,600     |
| Cash and cash equivalents at end of period                                      | \$ 11,735                     | \$ 26,555 |

See supplemental disclosures of cash flow information at Note 8.

See accompanying notes to condensed consolidated financial statements





## MERITAGE HOMES CORPORATION AND SUBSIDIARIES

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2004 AND 2003

## NOTE 1 ORGANIZATION AND BASIS OF PRESENTATION

**Basis of Presentation.** The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, and include the accounts of Meritage Homes Corporation and those of our consolidated subsidiaries. Intercompany balances and transactions have been eliminated in consolidation and certain prior year items have been reclassified to conform to our current financial statement presentation. In our opinion, these unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, necessary for the fair presentation of our financial position, results of operations and cash flows for the periods presented. The results of operations for any interim period are not necessarily indicative of results to be expected for a full fiscal year or for any future periods. These financial statements should be read in conjunction with our consolidated financial statements and footnotes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2003.

**Stock-Based Compensation.** At June 30, 2004, we had a stock-based employee compensation plan under which officers, key employees, non-employee directors and consultants may be granted options to purchase shares of our common stock. We apply the intrinsic value-based method of accounting for stock-based compensation prescribed in Accounting Principles Board ( APB ) Opinion No. 25 Accounting for Stock Issued to Employees , as allowed by SFAS No. 123 Accounting for Stock-Based Compensation and SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. Under this method, compensation expense is recorded on the date of the grant only if the market price of the underlying stock on the date of the grant was greater than the exercise price. SFAS No. 123 established accounting and disclosure requirements using a fair value-based method of accounting for stock-based employee compensation plans. We have adopted the disclosure requirements of SFAS No. 123. We have not issued options with exercise prices below the market value on the date of the grant; therefore, we have not recognized compensation expense for our stock-based plan. Had compensation cost for this plan been determined pursuant to SFAS No. 123, our net earnings and earnings per share would have been reduced to the following pro forma amounts. For the purpose of this disclosure, the value of the options is estimated by applying a Black-Scholes option pricing model and amortized to expense over the options vesting periods.

|                          |             | Three Months Ended June 30,              |           | Six Months Ended June 30, |           |
|--------------------------|-------------|--|-----------|---------------------------|-----------|
|                          |             | (in thousands, except per share amounts) |           |                           |           |
|                          |             | 2004                                     | 2003      | 2004                      | 2003      |
| Net earnings             | As reported | \$ 24,637                                | \$ 21,312 | \$ 51,556                 | \$ 37,085 |
|                          | Deduct*     | (1,179)                                  | (887)     | (2,037)                   | (1,762)   |
|                          | Pro forma   | \$ 23,458                                | \$ 20,425 | \$ 49,519                 | \$ 35,323 |
| Basic earnings per share | As reported | \$ 1.87                                  | \$ 1.64   | \$ 3.91                   | \$ 2.85   |
|                          | Pro forma   | \$ 1.78                                  | \$ 1.57   | \$ 3.75                   | \$ 2.71   |

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|                            |             |    |      |    |      |    |      |    |      |
|----------------------------|-------------|----|------|----|------|----|------|----|------|
| Diluted earnings per share | As reported | \$ | 1.77 | \$ | 1.55 | \$ | 3.69 | \$ | 2.70 |
|                            | Pro forma   | \$ | 1.69 | \$ | 1.49 | \$ | 3.54 | \$ | 2.58 |

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\*Deduct: Total stock-based employee compensation expense determined under fair value based method for awards, net of related tax effects.

The fair value for options granted in the first half of 2004 and 2003 was established at the date of grant using a Black-Scholes option pricing model with the following weighted average assumptions.

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|                          | Six Months Ended |       |
|--------------------------|------------------|-------|
|                          | June 30          |       |
|                          | 2004             | 2003  |
| Expected dividend yield  | 0%               | 0%    |
| Risk-free interest rate  | 4.42%            | 3.30% |
| Expected volatility      | 53%              | 55%   |
| Expected life (in years) | 7                | 7     |

The weighted average fair value of options was \$36.77 and \$18.62 for the six months ended June 30, 2004 and 2003, respectively.

We have generally granted options only to employees and non-employee directors. To date, the amount of compensation expense recorded in association with granting options to other individuals has not been material.

**Common Stock Repurchase.** In August 2002, our Board of Directors authorized the expenditure of up to \$32 million, with an increase of \$26.8 million approved in January 2004, to repurchase shares of our common stock. No date for completing the program has been determined, but we may purchase shares subject to applicable securities laws, and at times and in amounts as management deems appropriate. By June 30, 2004, we had repurchased 964,300 shares of our common stock under the August 2002 program at an average price of \$43.74 per share. 300,000 of these shares were repurchased in the second quarter of 2004, at an average price of \$66.18. In July 2004, we repurchased an additional 100,000 shares at an average price of \$60.87.

**Off-Balance Sheet Arrangements.** We often acquire finished building lots at market prices from various development entities under fixed price purchase agreements. This lot acquisition strategy reduces the financial requirements and risks associated with the direct ownership of undeveloped land. Under these purchase agreements, we are usually required to make deposits in the form of cash or letter of credit, which may be forfeited if we fail to perform under the agreement. At June 30, 2004, we had entered into purchase agreements with an aggregate purchase price of approximately \$1.4 billion, by making deposits of approximately \$124.5 million in the form of cash and approximately \$41.1 million in letters of credit.

On a limited basis, we also purchase finished lots from joint venture limited liability companies ( LLCs ). These LLCs are structured such that we are a non-controlling member and we are typically at risk only for the amounts we have invested. We enter into standard fixed price purchase agreements to buy lots from the LLCs, and we are not a borrower, guarantor or obligor on any of the LLCs' debt.

We also obtain letters of credit and performance, maintenance, and other bonds in support of our related obligations with respect to the development of our projects. The amount of these obligations outstanding at any time varies depending on the stage and level of our development activities. In the event the letters of credit or bonds are drawn upon, we would be obligated to reimburse the issuer of the letter of credit or bond. At June 30, 2004, we had approximately \$8.7 million in outstanding letters of credit and guarantees and \$173.4 million in performance bonds for such purposes. We believe it is unlikely that any of these letters of credit or bonds will be drawn upon.

*Warranty Reserves.* We have certain obligations related to post-construction warranties and defects related to homes sold. We have estimated these reserves based on historical data and trends with respect to similar product types and geographical areas. At June 30, 2004, we had approximately \$10.4 million in

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reserve for various warranty claims, an amount which we believe to be adequate, recorded in accrued liabilities on the accompanying consolidated balance sheets. Changes in our warranty reserve follow (in thousands):

|                              | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |          |
|------------------------------|--------------------------------|----------|------------------------------|----------|
|                              | 2004                           | 2003     | 2004                         | 2003     |
| Balance, beginning of period | \$ 9,987                       | \$ 7,212 | \$ 9,253                     | \$ 6,676 |
| Additions to reserve         | 2,143                          | 1,678    | 4,414                        | 3,333    |
| Warranty claims and expenses | (1,769)                        | (1,167)  | (3,306)                      | (2,286)  |
| Balance, end of period       | \$ 10,361                      | \$ 7,723 | \$ 10,361                    | \$ 7,723 |

**Recent Accounting Pronouncements.** In January 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities (FIN 46R), which governs whether certain transactions should be accounted for as on- or off-balance sheet transactions. We have adopted FIN 46R, and a discussion of its impact on our consolidated financial statements can be found in Note 3 Variable Interest Entities and Consolidated Real Estate Not Owned.

**NOTE 2 REAL ESTATE AND CAPITALIZED INTEREST**

Real estate consists of the following (in thousands):

|   | June 30, 2004 | December 31, 2003 |
|---|---------------|-------------------|
| Homes under contract under construction       | \$ 370,029    | \$ 281,931        |
| Finished home sites                           | 187,030       | 166,456           |
| Home sites under development                  | 114,978       | 97,141            |
| Unsold homes completed and under construction | 56,691        | 96,576            |
| Model homes                                   | 48,277        | 22,170            |
| Land held for development                     | 3,171         | 13,737            |
|   | \$ 780,176    | \$ 678,011        |

We capitalize all development period interest costs incurred in connection with the development and construction of real estate. Capitalized interest is allocated to real estate when incurred and charged to cost of home closings when the related property is delivered. Certain information regarding interest follows (in thousands):

|   | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|---|--------------------------------|-----------|------------------------------|-----------|
|   | 2004                           | 2003      | 2004                         | 2003      |
| Capitalized interest, beginning of period | \$ 14,583                      | \$ 10,412 | \$ 13,074                    | \$ 8,781  |
| Interest incurred and capitalized         | 9,441                          | 6,457     | 17,632                       | 12,119    |
| Amortization to cost of home closings     | (7,217)                        | (4,829)   | (13,899)                     | (8,860)   |
| Capitalized interest, end of period       | \$ 16,807                      | \$ 12,040 | \$ 16,807                    | \$ 12,040 |



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

FIN 46R Consolidation of Variable Interest Entities requires the consolidation of entities in which an enterprise absorbs a majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both, as a result of ownership, contractual or other financial interests in the entity. Prior to the issuance of FIN 46R, entities were generally consolidated by an enterprise when it had a controlling financial interest through ownership of a majority voting interest in the entity. FIN 46R applied immediately to variable interests created after January 31, 2003, and with respect to variable interests created before February 1, 2003, FIN 46R application was deferred and not required to be applied until the end of the first reporting period ending after March 15, 2004. Accordingly, we fully implemented FIN 46R by March 31, 2004.

Pursuant to FIN 46R, a variable interest entity, or VIE, is created when (i) the equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties or (ii) equity holders either (a) lack direct or indirect ability to make decisions about the entity, (b) are not obligated to absorb expected losses of the entity or (c) do not have the right to receive expected residual returns of the entity if they occur.

Based on the provisions of FIN 46R, we have concluded that when we enter into option or purchase agreements to acquire land or lots from an entity and pay a non-refundable deposit, a VIE is created because we are deemed to have provided subordinated financial support, which refers to variable interests that will absorb some or all of an entity's expected losses if they occur. For each VIE created where the fair value of the land or lots under contract are not more than half of the total fair value of the entity's assets, we are not deemed to be the primary beneficiary of the VIE and therefore do not consolidate the assets on our financial statements. For each VIE created where the fair value of the land or lots under contract are more than half of the total fair value of the entity's assets, then we compute expected losses and residual returns based on the probability of future cash flows as outlined in FIN 46R. If we are deemed to be the primary beneficiary of the VIE, because we are obligated to absorb the majority of the expected losses, receive the majority of the residual returns, or both, we will consolidate the VIE in our consolidated financial statements. Not all of our option agreements are determined to be VIEs.

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

We generally do not have any ownership interest in the VIEs that hold the lots and land under option or contract, and accordingly, we generally do not have legal or other access to the VIE's books or records. Therefore, it is not possible for us to compel the VIEs to provide financial or other data to us in performing our primary beneficiary evaluation. Accordingly, this lack of information from the VIEs may result in our evaluation being conducted primarily based on management judgments and estimates.

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





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We have evaluated all of our existing joint venture agreements and have determined that none of these joint ventures are VIEs. Therefore, we have not consolidated any of our joint venture agreements pursuant to the requirements of FIN 46R.

At June 30, 2004, the amount of lot option contracts recorded on our balance sheet under the category Consolidated real estate not owned is approximately \$28.3 million, of which approximately \$12.3 million represents the estimated fair value of specific performance options, and the remaining \$16.0 million represents the estimated fair value of consolidated VIEs. The corresponding credit relating to these assets of \$21.8 million is included under the category Obligations related to consolidated real estate not owned, which is net of option deposits totaling approximately \$6.5 million.

Below is a summary of our lots under option at June 30, 2004 (dollars in thousands):

|  | # of Lots | Fair Value | Purchase Price | Cash       | Option/Earnest Money Deposits | Letters of Credit |
|--|-----------|------------|----------------|------------|-------------------------------|-------------------|
| Specific performance options (1)   | 275       | \$ 12,292  | \$ 12,292      | \$ 778     |                               |                   |
| Options recorded on balance sheet (2)  | 535       | 16,044     | 16,158         | 5,719      |                               |                   |
| Total options recorded on balance sheet (2)  | 810       | 28,336     | 28,450         | 6,497      |                               |                   |
| Options/purchase contracts not consolidated on balance sheet non-refundable deposits (2) | 27,681    |            | 1,243,406      | 112,204    | \$                            | 41,080            |
| Options/purchase contracts not consolidated on balance sheet refundable deposits (3)     | 4,986     |            | 90,937         | 5,815      |                               |                   |
| Total options not consolidated on balance sheet  | 32,667    |            | 1,334,343      | 118,019    |                               | 41,080            |
| Total lots under option  | 33,477    | \$ 28,336  | \$ 1,362,793   | \$ 124,516 | \$                            | 41,080            |

Note: Except for our specific performance options, none of our option agreements require us to purchase lots. Our option to purchase lots remains effective so long as we purchase a pre-established minimum number of lots each month or quarter, as determined by the agreement. The pre-established number of lots typically is structured to approximate our expected rate of home orders.

- (1) Fair value of specific performance options approximates purchase price due to the short-lived nature of the options.
- (2) Deposits are non-refundable except if certain contractual conditions are not performed by the selling party.
- (3) Deposits are refundable at our sole discretion. Includes 2,449 lots under control for which we have not completed our acquisition evaluation process and we have not internally committed to purchase.

**NOTE 4 LOANS PAYABLE AND OTHER BORROWINGS AND SENIOR NOTES**

Loans payable and other borrowings consist of the following (in thousands):

|   | <b>June 30,<br/>2004</b> | <b>December 31,<br/>2003</b> |
|---|--------------------------|------------------------------|
| \$400 million unsecured revolving credit facility maturing May 2007 with extension provisions, and interest payable monthly approximating prime (4.0% at June 30, 2004) or LIBOR (approximately 1.635% at June 30, 2004) plus 2.0%. | \$ 16,400                | \$ 62,900                    |
| Acquisition and development seller carry back financing, interest payable at a fixed rate of 7.0% per annum, principal and interest payable on January 10, 2005, secured by a first deed of trust on real estate.                   | 600                      | 600                          |
| Model home lease program, with interest payable monthly approximating LIBOR (approximately 1.635% at June 30, 2004) plus 4.25%  | 32,396                   |                              |
| <b>Total loans payable and other borrowings</b>   | <b>\$ 49,396</b>         | <b>\$ 63,500</b>             |

Effective April 1, 2004, costs associated with model homes that we use to market our communities and that are built by us on lots owned by a third party and leased from them during our sales process, are included in the Company's financial statements. We do not legally own the model homes, but are reimbursed by the owner for our construction costs, and we have the right, but not the obligation, to purchase these homes. Any amounts received from the third party owner are recorded as debt and is generally repaid when the home is sold. Should we elect not to exercise our rights to purchase these model homes, the outstanding balance under the model home lease program will be eliminated upon the termination of the lease, which is generally between one and three years.

At June 30, 2004, our outstanding 9.75% senior notes due 2011 totaled approximately \$287.4 million, which includes \$155.0 million in principal amount issued in May 2001, and add-ons of \$51.3 million and \$81.1 million, including unamortized premiums, issued in February 2003 and September 2003, respectively. The add-on offerings of \$50 million and \$75 million in aggregate principal amount of our 9.75% senior notes were issued at prices of 103.25% and 109.0% of their face amounts to yield 9.054% and 7.642%, respectively, and together with the May 2001 offering, constitute a single series of notes.

On April 21, 2004, we issued \$130 million aggregate principal amount of 7% Senior Notes due 2014. The notes were priced to us at a slight premium implying an interest rate to us of 6.99%. We used the proceeds from the offering to pay down our senior credit facility and to repurchase shares of our common stock. At June 30, 2004, the outstanding balance on these notes totaled approximately \$130.1 million, including unamortized premium.

The bank credit facility and senior unsecured notes contain covenants which require maintenance of certain levels of tangible net worth and compliance with certain minimum financial ratios, place restrictions on the payment of dividends and redemptions of equity, and limit the incurrence of additional indebtedness, asset dispositions, mergers, certain investments and creations of liens, among other items. As of and for the six months ended June 30, 2004, we were in compliance with these covenants. The revolving credit facility and senior notes restrict our ability to pay dividends.

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Obligations to pay principal and interest on the bank credit facility and senior unsecured notes are guaranteed by all of our subsidiaries, each of which is directly or indirectly 100% owned by Meritage Homes Corporation (Guarantor Subsidiaries), other than certain minor subsidiaries (collectively, Non-Guarantor Subsidiaries). Such guarantees are full and unconditional, and joint and several. Separate financial statements

of the Guarantor Subsidiaries are not provided because Meritage Homes Corporation (the parent company) has no independent assets or operations, the guarantees are full and unconditional and joint and several, and the Non-Guarantor Subsidiaries are, individually and in the aggregate, minor. There are no significant restrictions on the ability of the parent company or any guarantor to obtain funds from its subsidiaries by dividend or loan.

**NOTE 5 ACQUISITIONS AND GOODWILL**

**Citation Homes of Southern California Acquisition.** Effective January 1, 2004, we purchased the homebuilding and related assets of Citation Homes of Southern California ( Citation ), which primarily operates in the Inland Empire region of the greater Los Angeles area. The purchase price was approximately \$24.2 million in cash, and we agreed to an earn-out of 20% of the pre-tax profits of the Southern California operations after capital charges, as defined, payable in cash over three years. The results of the Southern California operations are included in our consolidated financial statements beginning as of the effective date of the acquisition. See Note 8 for additional information regarding this acquisition.

**Goodwill.** Goodwill represents the excess of the purchase price of our acquisitions over the fair value of the assets acquired. The acquisition of the Southern California division was recorded using the purchase method of accounting. The purchase price was allocated based on estimated fair value of the assets and liabilities at the date of the acquisition. Intangible assets, equal to the excess purchase price over the fair value of the net assets, of \$11.2 million for the Southern California division were recorded as goodwill, which is presented on our consolidated balance sheet. The changes in the carrying amount of goodwill for the six months ended June 30, 2004 follow (in thousands):

|  | <b>Total</b> |
|--|--------------|
| Balance at December 31, 2003                   | \$ 75,645    |
| Goodwill acquired Southern California division | 11,214       |
| Increase due to earn-out agreements            | 1,805        |
| Balance at June 30, 2004                       | \$ 88,664    |

Under the guidelines contained in SFAS No. 142, Goodwill and Other Intangible Assets, we are required to test goodwill for impairment annually or more frequently if circumstances change or an event occurs that may reduce the value of an operating segment below its carrying value. In the first quarter of 2004 management performed a goodwill impairment analysis on each of our operating segments and determined that no impairment exists.

**NOTE 6 EARNINGS PER SHARE**

Basic and diluted earnings per share for the three and six months ended June 30, 2004 and 2003 were calculated as follows (in thousands, except per share amounts):

|  | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|--|--------------------------------|-----------|------------------------------|-----------|
|  | 2004                           | 2003      | 2004                         | 2003      |
| Basic average number of shares outstanding   | 13,146                         | 12,985    | 13,190                       | 13,013    |
| Effect of dilutive securities:   |                                |           |                              |           |
| Options to acquire common stock  | 766                            | 762       | 792                          | 702       |
| Diluted average shares outstanding   | 13,912                         | 13,747    | 13,982                       | 13,715    |
| Net earnings   | \$ 24,637                      | \$ 21,312 | \$ 51,556                    | \$ 37,085 |
| Basic earnings per share   | \$ 1.87                        | \$ 1.64   | \$ 3.91                      | \$ 2.85   |
| Diluted earnings per share   | \$ 1.77                        | \$ 1.55   | \$ 3.69                      | \$ 2.70   |
| Antidilutive stock options not included in the calculation of diluted earnings per share |                                | 10        |                              | 153       |

**NOTE 7 INCOME TAXES**

Components of income tax expense for the three and six months ended June 30, 2004 and 2003 are (in thousands):

|         | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|---------|--------------------------------|-----------|------------------------------|-----------|
|         | 2004                           | 2003      | 2004                         | 2003      |
| Federal | \$ 13,452                      | \$ 11,505 | \$ 28,110                    | \$ 20,019 |
| State   | 1,737                          | 1,247     | 3,623                        | 2,566     |
| Total   | \$ 15,189                      | \$ 12,752 | \$ 31,733                    | \$ 22,585 |

**NOTE 8 SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION**

Additional information related to our Consolidated Statement of Cash Flows follows (in thousands):

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The January 2004 acquisition of our Southern California division resulted in the following changes in assets and liabilities during the second quarter of 2004:

|  |    |          |
|--|----|----------|
| Increase in real estate                                      | \$ | (12,036) |
| Increase in deposits on real estate under option or contract |    | (1,870)  |
| Increase in receivables and other assets                     |    | (747)    |
| Increase in goodwill   |    | (11,214) |
| Increase in property and equipment                           |    | (89)     |
| Increase in accounts payable and accrued liabilities         |    | 1,704    |
| Increase in home sale deposits                               |    | 87       |
| Net cash paid for acquisition                                | \$ | (24,165) |

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|                                  | Six Months Ended June 30, |           |
|----------------------------------|---------------------------|-----------|
|                                  | 2004                      | 2003      |
| Cash paid during the period for: |                           |           |
| Interest                         | \$ 15,677                 | \$ 11,211 |
| Income taxes                     | \$ 36,948                 | \$ 26,166 |

**NOTE 9 SEGMENT INFORMATION**

We design, construct and build a broad range of single-family homes targeted to the needs of each of our markets. We are organized into five geographic homebuilding regions for internal reporting purposes. Each of these homebuilding regions have similar housing products, economic characteristics and class of prospective buyers, therefore, we have aggregated our geographic homebuilding regions into a single segment.

The accounting policies for the homebuilding regions are the same as ours. Prior to this quarter, we reported our regions (Texas, Arizona, California and Nevada) as separate segments, but after recent review and analysis, have concluded that consolidation into one segment is appropriate, as homebuilding is our primary business.

**NOTE 10 RESTATEMENT**

In January 2005 we determined that construction costs associated with model homes used to market our communities and that are built by us on lots owned by a third party and leased from them during our sales process, should be included in the Company's financial statements. We do not legally own the model homes, but we are reimbursed by the owner for our construction costs, and we have the right, but not the obligation, to purchase these homes. For accounting purposes, we are deemed to be the owner of the model homes, and due to our continuing involvement with these assets, we are unable to derecognize the model homes upon their completion and commencement of the lease. Amounts received by us from the third party owners for reimbursement of our construction costs are recorded as debt in our financial statements, which is generally deemed repaid when the homes are sold. In addition, we determined that payments related to the lease program should be recognized as interest expense, subject to capitalization, rather than commissions and other sales costs, which is included in cost of home closings. As a result, the accompanying unaudited condensed consolidated financial statements as of and for the three and six months ended June 30, 2004 have been restated from the amounts previously reported to reflect the above described treatment for our model home lease program. The restated amounts reflect an additional \$32.4 million of real estate assets and debt and approximately \$0.4 million in lease payments under our model home lease program since April 1, 2004 as interest, which is included in cost of home closings rather than commissions and other sales costs. Financial statements for periods prior to June 30, 2004 were not materially affected and have not been restated. There was no material impact resulting from the change on net earnings and basic and diluted EPS for the three and six months ended June 30, 2004.

A summary of the significant effects of the restatement is as follows:

|  | As of June 30, 2004    |             |
|--|------------------------|-------------|
|  | As Previously Reported | As Restated |
|  | (in thousands)         |             |
| Real estate                                | \$ 747,780             | \$ 780,176  |
| Total assets                               | 1,080,928              | 1,113,324   |
| Loans payable and other borrowings         | 17,000                 | 49,396      |
| Total liabilities                          | 633,490                | 665,886     |
| Total liabilities and stockholders' equity | 1,080,928              | 1,113,324   |





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|                                   | Three Months Ended June 30, 2004 |              | Six Months Ended June 30, 2004 |              |
|-----------------------------------|----------------------------------|--------------|--------------------------------|--------------|
|                                   | As Previously<br>Reported        | As Restated  | As Previously<br>Reported      | As Restated  |
|                                   | (in thousands)                   |              | (in thousands)                 |              |
| Cost of home closings             | \$ (352,208)                     | \$ (352,568) | \$ (692,547)                   | \$ (692,907) |
| Commissions and other sales costs | (26,356)                         | (25,996)     | (52,189)                       | (51,829)     |

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

This Quarterly Report on Form 10-Q contains forward-looking statements. The words believe, expect, anticipate, forecast, plan and project and similar expressions identify forward-looking statements, which speak only as of the date the statement was made. All such statements are within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements may include, but are not limited to, projections of revenue, income or loss, capital expenditures and backlog; plans for future operations; financing needs or plans and liquidity; the impact of changes in interest rates; plans relating to our products or services, acquisitions, and new or planned development projects; the demand for and pricing of our homes; the expected outcome of legal proceedings against us; the growth potential of the markets we operate in; the sufficiency of our capital resources to support our growth strategy; the sufficiency of our warranty and other reserves; the number of new communities we plan to open in Nevada during the remainder of 2004; the impact of new accounting principles; and our ability to continue positive operating results in light of current economic and political conditions, as well as assumptions relating to the foregoing.

Actual events and results may differ materially from those expressed in forward-looking statements due to a number of factors. Risks identified in Exhibit 99.1 to this Quarterly Report on Form 10-Q/A and in our Annual Report on Form 10-K for the year ended December 31, 2003, including those under the caption Management's Discussion and Analysis of Financial Condition and Results of Operations - Factors That May Affect Our Future Results and Financial Condition describe factors, among others, that could contribute to or cause such differences. These factors may also affect our business generally and as a result, our stock and note prices may fluctuate dramatically.

### *Overview*

Meritage Homes Corporation is a leading designer and builder of single-family homes in the rapidly growing Sunbelt states of Texas, Arizona, California and Nevada, based on the number of homes closed. We focus on providing a broad range of first-time, move-up and luxury homes to our targeted customer base. We have operated in Arizona since 1985, in Texas since 1987, in California since 1989 and in Nevada since 2002. We entered the Inland Empire market of Southern California in January 2004 with our acquisition of Citation Homes of Southern California (See Notes 5 and 8 to the condensed consolidated financial statements). In April 2004 we began start-up operations in the Denver, Colorado market. We operate in these states, predominantly in one industry, homebuilding, and thus have only one single reportable segment.

We operate in Texas as Legacy Homes, Monterey Homes and Hammonds Homes, in Arizona as Monterey Homes and Meritage Homes, in California and Colorado as Meritage Homes and in Nevada as Perma-Bilt Homes. At June 30, 2004, we were actively selling homes in 137 communities, with base prices ranging from \$98,000 to \$867,000.

Total home closing revenue was \$431.3 million for the three months ended June 30, 2004, increasing \$105.6 million, or 32% from \$325.7 million for the same period last year. Net earnings for the second quarter of 2004 increased \$3.3 million, or 16%, to \$24.6 million from \$21.3 million in the same quarter of 2003. These increases were primarily driven by the effect of higher home closings and revenues.

In April 2004 we issued \$130 million aggregate principal amount of 7% senior notes due 2014. The proceeds from this offering were used to pay down our senior credit facility and to repurchase shares of our common stock. We believe this will provide us with long-term strategic capital at an attractive cost.



***Critical Accounting Policies***

We have established various accounting policies, which govern the application of accounting principles generally accepted in the United States of America in the preparation and presentation of our consolidated financial statements. Our significant policies are described in Note 1 of the consolidated financial statements in our Annual Report on Form 10-K for December 31, 2003. Certain of these policies involve significant judgments, assumptions and estimates made by management that have a material impact on the carrying value of certain assets and liabilities, and revenues and costs. The judgments, assumptions and estimates we use and believe to be critical to our business are based on historical experience, knowledge of the accounts and other factors, which we believe to be reasonable under the circumstances. We evaluate our judgments and assumptions on an on-going basis. Because of the nature of the judgments and assumptions made, actual results may differ from these judgments and estimates, which could have a material impact on the carrying values of assets and liabilities, and the results of our operations.

The accounting policies that we deem most critical to us, and involve the most difficult, subjective or complex judgments, include our estimates of costs to complete our individual projects, the ultimate recoverability (or impairment) of these costs, goodwill impairment, the likelihood of closing lots held under option or contract, the ability to determine the fair value of consolidated real estate not owned and liabilities related to such, certain estimates and assumptions related to applying FIN 46R, and the ability to estimate expenses and accruals, including legal and warranty reserves. Should we under or over estimate costs to complete individual projects, gross margins in a particular period could be misstated and the ultimate recoverability of costs related to a project from home sales may be uncertain. Furthermore, non-refundable deposits paid for land options or contracts may have no economic value to us if we do not ultimately purchase the land. Our inability to accurately estimate expenses, accruals, or an impairment of real estate or goodwill could result in charges, or income, in future periods, which relate to activities or transactions in a preceding period. The estimates and assumptions we make relating to our application of FIN 46R, if not accurate, could result in us incorrectly including, or excluding, certain contractual land acquisition arrangements as variable interest entities in, or from, respectively, our consolidated financial statements.

***Results Of Operations***

The following discussion and analysis of financial condition and results of operations is based on our unaudited condensed consolidated financial statements for the three and six-month periods ended June 30, 2004 and 2003.

***Home Closing Revenue, Home Orders and Order Backlog***

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

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|                             | Three Months Ended<br>June 30, |            |  | %<br>Change | Six Months Ended<br>June 30, |            |  | %<br>Change |
|-----------------------------|--------------------------------|------------|--|-------------|------------------------------|------------|--|-------------|
|                             | 2004                           | 2003       |  |             | 2004                         | 2003       |  |             |
| <b>Home Closing Revenue</b> |                                |            |  |             |                              |            |  |             |
| <u>Total</u>                |                                |            |  |             |                              |            |  |             |
| Dollars                     | \$ 431,275                     | \$ 325,733 |  | 32%         | \$ 854,777                   | \$ 609,143 |  | 40%         |
| Homes closed                | 1,620                          | 1,258      |  | 29%         | 3,189                        | 2,394      |  | 33%         |
| Average sales price         | \$ 266.2                       | \$ 258.9   |  | 3%          | \$ 268.0                     | \$ 254.4   |  | 5%          |
| <u>Texas</u>                |                                |            |  |             |                              |            |  |             |
| Dollars                     | \$ 160,377                     | \$ 130,253 |  | 23%         | \$ 317,649                   | \$ 251,756 |  | 26%         |
| Homes closed                | 741                            | 641        |  | 16%         | 1,471                        | 1,247      |  | 18%         |
| Average sales price         | \$ 216.4                       | \$ 203.2   |  | 6%          | \$ 215.9                     | \$ 201.9   |  | 7%          |
| <u>Arizona</u>              |                                |            |  |             |                              |            |  |             |
| Dollars                     | \$ 115,535                     | \$ 83,184  |  | 39%         | \$ 213,467                   | \$ 150,309 |  | 42%         |
| Homes closed                | 473                            | 291        |  | 63%         | 854                          | 541        |  | 58%         |
| Average sales price         | \$ 244.3                       | \$ 285.9   |  | (15)%       | \$ 250.0                     | \$ 277.8   |  | (10)%       |
| <u>California</u>           |                                |            |  |             |                              |            |  |             |
| Dollars                     | \$ 123,840                     | \$ 77,952  |  | 59%         | \$ 254,710                   | \$ 145,255 |  | 75%         |
| Homes closed                | 294                            | 176        |  | 67%         | 601                          | 334        |  | 80%         |
| Average sales price         | \$ 421.2                       | \$ 442.9   |  | (5)%        | \$ 423.8                     | \$ 434.9   |  | (3)%        |
| <u>Nevada</u>               |                                |            |  |             |                              |            |  |             |
| Dollars                     | \$ 31,523                      | \$ 34,344  |  | (8)%        | \$ 68,951                    | \$ 61,823  |  | 12%         |
| Homes closed                | 112                            | 150        |  | (25)%       | 263                          | 272        |  | (3)%        |
| Average sales price         | \$ 281.5                       | \$ 229.0   |  | 23%         | \$ 262.2                     | \$ 227.3   |  | 15%         |
| <b>Home Orders</b>          |                                |            |  |             |                              |            |  |             |
| <u>Total</u>                |                                |            |  |             |                              |            |  |             |
| Dollars                     | \$ 700,142                     | \$ 463,189 |  | 51%         | \$ 1,292,141                 | \$ 876,053 |  | 47%         |
| Homes ordered               | 2,556                          | 1,877      |  | 36%         | 4,749                        | 3,459      |  | 37%         |
| Average sales price         | \$ 273.9                       | \$ 246.8   |  | 11%         | \$ 272.1                     | \$ 253.3   |  | 7%          |
| <u>Texas</u>                |                                |            |  |             |                              |            |  |             |
| Dollars                     | \$ 220,056                     | \$ 181,602 |  | 21%         | \$ 419,913                   | \$ 342,737 |  | 23%         |
| Homes ordered               | 1,022                          | 883        |  | 16%         | 1,969                        | 1,674      |  | 18%         |
| Average sales price         | \$ 215.3                       | \$ 205.7   |  | 5%          | \$ 213.3                     | \$ 204.7   |  | 4%          |
| <u>Arizona</u>              |                                |            |  |             |                              |            |  |             |
| Dollars                     | \$ 262,004                     | \$ 153,252 |  | 71%         | \$ 470,392                   | \$ 276,905 |  | 70%         |
| Homes ordered               | 1,056                          | 605        |  | 75%         | 1,863                        | 1,052      |  | 77%         |
| Average sales price         | \$ 248.1                       | \$ 253.3   |  | (2)%        | \$ 252.5                     | \$ 263.2   |  | (4)%        |
| <u>California</u>           |                                |            |  |             |                              |            |  |             |
| Dollars                     | \$ 185,725                     | \$ 75,095  |  | 147%        | \$ 345,556                   | \$ 164,870 |  | 110%        |
| Homes ordered               | 387                            | 169        |  | 129%        | 752                          | 349        |  | 115%        |
| Average sales price         | \$ 479.9                       | \$ 444.3   |  | 8%          | \$ 459.5                     | \$ 472.4   |  | (3)%        |
| <u>Nevada</u>               |                                |            |  |             |                              |            |  |             |
| Dollars                     | \$ 32,357                      | \$ 53,240  |  | (39)%       | \$ 56,280                    | \$ 91,541  |  | (39)%       |
| Homes ordered               | 91                             | 220        |  | (59)%       | 165                          | 384        |  | (57)%       |
| Average sales price         | \$ 355.6                       | \$ 242.0   |  | 47%         | \$ 341.1                     | \$ 238.4   |  | 43%         |

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|                      | 2004 | At June 30, | 2003 | %<br>Change |       |
|----------------------|------|-------------|------|-------------|-------|
| <b>Order Backlog</b> |      |             |      |             |       |
| <u>Total</u>         |      |             |      |             |       |
| Dollars              | \$   | 1,169,109   | \$   | 804,674     | 45%   |
| Homes in backlog     |      | 4,215       |      | 3,135       | 34%   |
| Average sales price  | \$   | 277.4       | \$   | 256.7       | 8%    |
| <u>Texas</u>         |      |             |      |             |       |
| Dollars              | \$   | 343,683     | \$   | 309,880     | 11%   |
| Homes in backlog     |      | 1,617       |      | 1,512       | 7%    |
| Average sales price  | \$   | 212.5       | \$   | 204.9       | 4%    |
| <u>Arizona</u>       |      |             |      |             |       |
| Dollars              | \$   | 495,284     | \$   | 270,751     | 83%   |
| Homes in backlog     |      | 1,841       |      | 977         | 88%   |
| Average sales price  | \$   | 269.0       | \$   | 277.1       | (3)%  |
| <u>California</u>    |      |             |      |             |       |
| Dollars              | \$   | 289,175     | \$   | 156,542     | 85%   |
| Homes in backlog     |      | 631         |      | 348         | 81%   |
| Average sales price  | \$   | 458.3       | \$   | 449.8       | 2%    |
| <u>Nevada</u>        |      |             |      |             |       |
| Dollars              | \$   | 40,967      | \$   | 67,501      | (39)% |
| Homes in backlog     |      | 126         |      | 298         | (58)% |
| Average sales price  | \$   | 325.1       | \$   | 226.5       | 44%   |

**Home Closing Revenue.** The increase in total home closing revenue in the second quarter and first six months of 2004 compared to the same periods of 2003 resulted mainly from increases in the number of homes closed of 29% and 33%, respectively, as well as increases in average sales price of 3% and 5%, respectively. The increases in the number of homes closed and home closing revenue in California can be attributed to both a strong housing market and an increase in our number of active communities. The increase in the number of communities in California is partially due to the acquisition of our Southern California division, which was effective January 1, 2004. In Arizona, the increases are the result of a healthy housing market and a significant upswing in orders per community. The decrease in average selling prices in Arizona for the second quarter and the first six months was due to a significant increase in closings of our more moderately priced Meritage homes, while closings of our higher-priced Monterey product remained relatively stable. In Texas the increases were primarily the result of a 24% increase in the number of active communities, from 70 at June 30, 2003 to 87 at June 30, 2004. The reduction in the second quarter of the number and dollar value of home closings in Nevada resulted from the rapid sellout of existing communities for which replacement communities have not yet opened.

**Home Orders.** Home orders for any period represent the aggregate sales price of homes ordered by customers, net of cancellations. We do not include sales that are contingent upon the sale of a customer's existing home as an order until the contingency is removed. Historically, we have experienced a cancellation rate approximating 25% or less of gross sales, which we believe is consistent with industry standards. The demand for our homes was strong during the second quarter and first six months of 2004, as evidenced by increases in sales orders of 36% and 37%, respectively, over the same periods in 2003. In California, the number of our actively selling communities increased 89% over the past twelve months, from nine at June 30, 2003 to 17 at June 30, 2004. This increase in communities and a strong housing market in California are driving the increase in home orders. In Arizona, where the housing market is also

very strong, orders per community doubled from 31 during the first half of 2003 to 62 during the first half of 2004. The reduction in order activity in Nevada was directly the result of the rapid sellout of communities during the latter part of 2003. We had only one actively selling community in Nevada during the first quarter and much of the second



quarter. In the latter part of the second quarter, we opened two communities for sales and anticipate opening another five during the second half of the year.

**Order Backlog.** Backlog represents home orders that have not yet closed. Total dollar backlog at June 30, 2004 increased 45% over the June 30, 2003 amount due to a 34% increase in the number of homes in backlog and an 8% increase in the average selling price of those homes.

As a result of the significant increase in order activity in California and Arizona, the number of homes in backlog increased 81% and 88%, respectively, from June 30, 2003 to June 30, 2004. In Texas, the increase in the number of homes in backlog was mainly due to a 24% increase in actively selling communities over the past twelve months, from 70 at June 30, 2003 to 87 at June 30, 2004. The backlog decrease in Nevada was due to the earlier than anticipated sellout of some communities ahead of opening their replacements.

**Other Operating Information (dollars in thousands)**

|  | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |            |
|--|--------------------------------|-----------|------------------------------|------------|
|  | 2004                           | 2003      | 2004                         | 2003       |
| <b>Home Closing Gross Profit</b>         |                                |           |                              |            |
| Dollars                                  | \$ 78,707                      | \$ 65,364 | \$ 161,870                   | \$ 121,718 |
| Percent of home closing revenue          | 18.3%                          | 20.1%     | 18.9%                        | 20.0%      |
| <b>Commissions and Other Sales Costs</b> |                                |           |                              |            |
| Dollars                                  | \$ 25,996                      | \$ 21,328 | \$ 51,829                    | \$ 41,073  |
| Percent of home closing revenue          | 6.0%                           | 6.5%      | 6.1%                         | 6.7%       |
| <b>General and Administrative Costs</b>  |                                |           |                              |            |
| Dollars                                  | \$ 16,794                      | \$ 12,076 | \$ 32,850                    | \$ 24,288  |
| Percent of total revenue                 | 3.9%                           | 3.6%      | 3.8%                         | 3.9%       |
| <b>Income Taxes</b>                      |                                |           |                              |            |
| Dollars                                  | \$ 15,189                      | \$ 12,752 | \$ 31,733                    | \$ 22,585  |
| Percent of earnings before income taxes  | 38.1%                          | 37.4%     | 38.1%                        | 37.8%      |

**Home Closing Gross Profit.** Home closing gross profit equals home closing revenue, less the cost of home closings, which include developed lot costs, home construction costs, an allocation of common community costs (such as the cost of model complex and architectural, legal and zoning costs), amortization of capitalized interest, sales tax, warranty, construction overhead and closing costs. The dollar increases in gross profit for the three and six months ended June 30, 2004 are attributable to the increase in the number and dollar value of homes closed. The decrease in home closing gross profit percentages for both periods was primarily caused by margin compression in Texas and Nevada. In Texas, the Dallas/Ft. Worth housing market is not as strong as it was during the first half of 2003, creating pricing pressures, which affected our gross profit percentage. In Nevada, where the housing market is strong, the reduction in gross profit percentage was due to a short-term fluctuation in deliveries of homes with lower margins.

**Commissions and Other Sales Costs.** Commissions and other sales costs, such as advertising and sales office expenses, were 6.0% of home closing revenue, in the three months ended June 30, 2004, as compared to 6.5% of home closing

revenue in the second quarter of 2003. For the first six months of 2004, commissions and other sales costs were also 6.1% of home closing revenue, compared with 6.7%, of home closing revenue for the first half of 2003. The reduction in commissions and other sales costs as a percentage of home closing revenue for both periods was primarily due to the leveraging of fixed and semi-fixed sales and marketing costs over a larger number of communities in the areas in which we operate.

*General and Administrative Costs.* General and administrative costs represent corporate and divisional overhead expenses such as salaries and bonuses, occupancy, insurance and travel expenses. General and

administrative costs as a percentage of total revenue for the second quarter of 2004 increased to 3.9% from 3.6% in the second quarter of 2003. This slight increase was due to the somewhat fixed nature of most of our general and administrative costs. For the first six months of 2004, general and administrative costs as a percentage of total revenue were relatively stable as compared to the first six months of 2003.

**Income Taxes.** The increases in the dollar value of income taxes for the three and six months ended June 30, 2004 from the prior year resulted from increases in pre-tax earnings. On a percentage basis, we experienced an increase in the effective tax rate to 38.1% for the three and six months ended June 30, 2004, up slightly from 37.4% and 37.8%, respectively, in 2003. These increases were due to decreased revenue in Texas and Nevada as a percentage of total revenue, which are states with limited corporate state income tax.

#### ***Liquidity and Capital Resources***

Our principal uses of capital for the quarter ended June 30, 2004 were operating expenses, land and property purchases, lot development, home construction, repurchases of common stock, income taxes, interest and investments in joint ventures. We used a combination of borrowings and funds generated by operations to meet our short-term working capital requirements.

Cash flows for each of our communities depend on the status of the development cycle, and can differ substantially from reported earnings. Early stages of development or expansion require significant cash outlays for land acquisitions, plat and other approvals, and construction of model homes, roads, utilities, general landscaping and other amenities. These costs are capitalized, therefore they would not be included in income reported for financial statement purposes during early development stages but would be expensed to cost of sales in a later period.

At June 30, 2004, there was a balance of \$16.4 million outstanding under our senior unsecured revolving credit facility and approximately \$49.8 million was outstanding in letters of credit and guarantees that collateralize our obligations under various land purchase and other contracts. After considering our most restrictive bank covenants, our borrowing availability under the bank credit facility was approximately \$115.1 million at June 30, 2004, as determined by borrowing base limitations defined by our agreement with the lending banks.

At June 30, 2004, our outstanding 9.75% senior notes due 2011 totaled approximately \$287.5 million, which includes unamortized premiums of approximately \$7.5 million. Our annual debt service requirement for our 9.75% senior notes is \$27.3 million.

In April 2004, we issued \$130 million in aggregate principal amount of 7% senior notes due 2014. The proceeds from this offering were used to pay down our credit facility and repurchase shares of our common stock. We believe this issuance provides us with long-term strategic capital at an attractive cost and increases the availability under our unsecured credit facility. At June 30, 2004, the outstanding balance on these notes totaled approximately \$130.1 million, including unamortized premium.

Effective April 1, 2004, costs associated with model homes that we use to market our communities and that are built by us on lots owned by a third party and leased from them during our sales process, are included in the Company's financial statements. We do not legally own the model

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homes, but we are reimbursed by the owner for our construction costs, and we have the right, but not the obligation, to purchase these homes. Any amounts received from the third party owners are recorded as debt and is generally repaid when the homes are sold. Should we elect not to exercise our rights to purchase these model homes, the outstanding balance under the model home lease program will be eliminated upon the termination of the lease, which is generally between one and three years.

We believe that our current borrowing capacity, cash on hand at June 30, 2004, and anticipated net cash flows from operations will be sufficient to meet liquidity needs for the foreseeable future. We believe our future cash needs will include funds for the completion of projects that are underway, the maintenance of our

day-to-day operations, and the acquisition or start-up of additional homebuilding operations, should the opportunities arise. There is no assurance, however, that future cash flows will be sufficient to meet future capital needs. The amount and types of indebtedness that we may incur may be limited by the terms of the indentures governing our senior notes and by the terms of the credit agreement governing our senior unsecured credit facility.

#### *Off-Balance Sheet Arrangements*

Reference is made to Notes 1 and 3 to the Notes to Consolidated Financial Statements included in this Form 10-Q/A.

#### *Seasonality*

We historically have closed more homes in the second half of the fiscal year than in the first half, due in part to the slightly seasonal nature of the market for our move-up and semi-custom luxury products. We expect this seasonal trend to continue, although it may vary if our operations continue to expand.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We are exposed to market risk in the ordinary course of business primarily related to potential adverse changes in interest rates on our existing revolving credit facility. The interest rate relative to this borrowing fluctuates with the prime and Eurodollar lending rates. As of June 30, 2004, we had approximately \$16.4 million drawn under our revolving credit facility that is subject to changes in interest rates. We do not believe our exposure in this area is material to our cash flows or earnings. We do not enter into, or intend to enter into, derivative financial instruments for trading or speculative purposes.

Our fixed rate debt is made up primarily of our \$280.0 million in principal of 9.75% senior notes and \$130 million in principal of 7% senior notes. Except in limited circumstances, we do not have an obligation to prepay our fixed-rate debt prior to maturity and, as a result, interest rate risk and changes in fair value should not have a significant impact on the fixed rate borrowings until we would be required to refinance such debt.

Our operations are interest rate sensitive. As overall housing demand is adversely affected by increases in interest rates, a significant increase in mortgage interest rates may negatively affect the ability of homebuyers to secure adequate financing. Higher interest rates could adversely affect our revenues, gross margins and net income and would also increase our variable rate borrowing costs.

### **Item 4. Controls and Procedures**

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*This section has been updated for events and developments occurring subsequent to the filing of the Original 10-Q through February 18, 2005.*

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to our management, including our Co-Chief Executive Officers and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

We regularly evaluate our internal control over financial reporting and discuss these matters with our audit committee. As a result of the restatement of our condensed consolidated financial statements for the three and six months ended June 30, 2004 discussed in Note 10 to the financial statements, we concluded in February 2005 that there was a material weakness (as defined under Standard No. 2 of the Public Company Accounting Oversight Board) in our internal control over financial reporting relating to the accounting for our

model home lease program. Although the dollar amounts relating to the adjustment were immaterial to our results of operations and liquidity, our management and the audit committee reviewed and analyzed our internal controls, policies and procedures in response to this material weakness. We believe that our model home lease program transactions are highly technical in nature. Meritage management has taken exhaustive efforts to document its assumptions and conclusions related to all complex transactions. Additionally, Meritage management has hired additional financial and accounting staff, enhanced the training of our finance and accounting staff and requires periodic review of a wider variety of current technical accounting literature.

While the restatement did not have any effect on our most restrictive debt covenants, operating or net earnings, it did affect two line items on our consolidated balance sheet: real estate and loans payable and other borrowings, two line items on our consolidated statement of earnings: commissions and other sales costs and cost of home closings and two line items on our consolidated statement of cash flows: increase in real estate and proceeds from loans payable and other borrowings.

As required by Rule 13a-15(b) under the Exchange Act and in light of the restatement of our consolidated balance sheet, statement of earnings and statement of cash flows, we conducted an evaluation, under the supervision and with participation of our management, including our Co-Chief Executive Officers and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report and as of February 9, 2005. Based on the foregoing, our management, including our Co-Chief Executive Officers and our Chief Financial Officer, concluded that the material weakness had been remediated and that our disclosure controls and procedures were effective at the reasonable assurance level as of February 21, 2005.

**PART II - OTHER INFORMATION****Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities**

In May 1999, we announced a stock repurchase program in which our Board of Directors approved the repurchase of up to \$6 million of outstanding Meritage common stock. The amount was increased to \$20 million in July 2000. Under this program, which ended in September 2001, we repurchased 1,637,926 shares at an average price of \$6.85.

In August 2002, our Board of Directors authorized the expenditure of up to \$32 million to repurchase shares of our common stock. In January 2004, our Board of Directors approved an increase in this amount of \$26.8 million. No date for completing the program has been determined, but we will purchase shares subject to applicable securities law, and at times and in amounts as management deems appropriate.

During the three months ended June 30, 2004, we repurchased the following shares under our stock repurchase program (amounts in thousands, except per share amounts):

| Period                          | Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Dollar Amount of Shares that May Yet Be Purchased under the Plans or Programs |
|---------------------------------|----------------------------|------------------------------|--|---|
| April 1, 2004 to April 30, 2004 | 25                         | \$ 69.20                     | 2,327  |   |
| May 1, 2004 to May 31, 2004     | 275                        | \$ 65.90                     | 2,602  |   |
| June 1, 2004 to June 30, 2004   | 300                        | \$ 66.18                     | 2,602  | \$ 16,617   |

**Item 4. Submission of Matters to a Vote of Security Holders**

Our Annual Meeting of Stockholders was held on May 12, 2004. At the Annual Meeting, the stockholders elected Steven J. Hilton, Raymond (Ray) Oppel and William G. Campbell to serve as Directors for a two-year term. John R. Landon, Robert G. Sarver, Peter L. Ax and C. Timothy White continued as Directors after the meeting.

Stockholders holding 12,715,342 shares or 95.7% of the outstanding shares were present in person or by proxy at the Annual Meeting. The tabulation with respect to each nominee for director follows:

**Votes For**



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|                     |            | <b>Votes Against<br/>or Withheld</b> |
|---------------------|------------|--------------------------------------|
| Steven J. Hilton    | 11,871,595 | 843,747                              |
| Raymond (Ray) Opper | 11,475,266 | 1,240,076                            |
| William G. Campbell | 11,516,308 | 1,199,034                            |

Stockholders also approved an amendment to the Meritage Stock Option Plan. The results of the vote were as follows:

| <b>Votes For</b> | <b>Votes Against</b> | <b>Votes Abstain</b> | <b>Broker Non-Vote</b> |
|------------------|----------------------|----------------------|------------------------|
| 9,196,037        | 2,147,193            | 18,499               | 1,353,613              |

**Item 6. Exhibits and Reports on Form 8-K**

**(a) Exhibits**

| <b>Exhibit Number</b> | <b>Description</b>   | <b>Page or Method of Filing</b> |
|-----------------------|--|---------------------------------|
| 10.1                  | Revised Amendment to Employment Agreements between the Company and Steven J. Hilton and John R. Landon | Previously Filed                |
| 10.2                  | Revised Amendment to Employment Agreement between the Company and Larry W. Seay                        | Previously Filed                |
| 31.1                  | Rule 13a-14(a)/15(d)-14(a) Certificate of Steven J. Hilton, Co-Chief Executive Officer                 | Filed Herewith                  |
| 31.2                  | Rule 13a-14(a)/15(d)-14(a) Certificate of John R. Landon, Co-Chief Executive Officer                   | Filed Herewith                  |
| 31.3                  | Rule 13a-14(a)/15(d)-14(a) Certificate of Larry W. Seay, Chief Financial Officer                       | Filed Herewith                  |
| 32.1                  | Section 1350 Certification of Officers   | Filed Herewith                  |
| 99.1                  | Private Securities Reform Act of 1995 Safe Harbor Compliance Statement for Forward-Looking Statements  | Previously Filed                |

**(b) Reports on Form 8-K**

- (1) On June 22, 2004 we filed a report on Form 8-K for the purpose of reporting a change of the Company's independent auditors.
- (2) On June 30, 2004 we filed a report of Form 8-K/A to clarify certain information with respect to the change in our independent auditors.
- (3) On July 7, 2004 we filed a Current Report on Form 8-K for the purpose of furnishing a press release related to the announcement of Meritage's second quarter 2004 new orders, closings and backlog.
- (4) On July 21, 2004 we filed a Current Report on Form 8-K for the purpose of furnishing a press release related to the announcement of Meritage's second quarter 2004 earnings and other results.



**INDEX OF EXHIBITS**

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