

THIS QUARTERLY REPORT IS BEING PREPARED PURSUANT TO REQUIREMENTS CONTAINED IN THE INDENTURE, DATED AS OF FEBRUARY 6, 2013 GOVERNING THE 6.875% SENIOR NOTES DUE 2021 ISSUED BY ASHTON WOODS USA L.L.C.

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

For the quarterly period ended November 30, 2016

OR

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

For the transition period from _____ to _____.

Ashton Woods USA L.L.C.

(Exact Name of Registrant as Specified in Its Charter)

Commission file Number: N/A

<u>Nevada</u> (State or Other Jurisdiction of Incorporation or Organization)	<u>37-1590746</u> (I.R.S. Employer Identification No.)
<u>1405 Old Alabama Road Suite 200 Roswell, GA</u> (Address of Principal Executive Offices)	<u>30076</u> (Zip Code)
<u>(770) 998-9663</u> Registrant's telephone number, including area code	

Securities registered pursuant to Section 12(b) of the Act: Title of Each Class <u>NONE</u>	Securities registered pursuant to Section 12(g) of the Act: Title of Each Class <u>NONE</u>
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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ___ No X

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes X No ___

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 ___ N/A X

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, 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 ___ N/A X

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 definition of "accelerated filer," "large accelerated filer" and smaller company: in Rule 12b-2 of the Exchange Act. (Check One):

Large accelerated filer ___ Accelerated filer ___ Non-accelerated filer X 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 X

ASHTON WOODS USA L.L.C.
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Review Report of Independent Auditors

The Members of Ashton Woods USA L.L.C.

We have reviewed the condensed consolidated financial information of Ashton Woods USA L.L.C., which comprise the condensed consolidated balance sheet as of November 30, 2016, and the related condensed consolidated statements of income for the three-month and six-month periods ended November 30, 2016 and 2015, condensed consolidated statements of cash flows for the six-month periods ended November 30, 2016 and 2015, and condensed consolidated statement of members' equity for each of the three-month periods in the six-month period ended November 30, 2016.

Management's Responsibility for the Financial Information

Management is responsible for the preparation and fair presentation of the condensed financial information in conformity with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control sufficient to provide a reasonable basis for the preparation and fair presentation of interim financial information in conformity with U.S. generally accepted accounting principles.

Auditor's Responsibility

Our responsibility is to conduct our review in accordance with auditing standards generally accepted in the United States applicable to reviews of interim financial information. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States, the objective of which is the expression of an opinion regarding the financial information. Accordingly, we do not express such an opinion.

Conclusion

Based on our review, we are not aware of any material modifications that should be made to the condensed consolidated financial information referred to above for it to be in conformity with U.S. generally accepted accounting principles.



Report on Condensed Balance Sheet as of May 31, 2016

We have previously audited, in accordance with auditing standards generally accepted in the United States, the consolidated balance sheet of Ashton Woods USA L.L.C. as of May 31, 2016, and the related consolidated statements of income, members' equity, and cash flows for the year then ended (not presented herein); and we expressed an unmodified audit opinion on those audited consolidated financial statements in our report dated July 20, 2016. In our opinion, the accompanying condensed consolidated balance sheet of Ashton Woods USA L.L.C. as of May 31, 2016, is consistent, in all material respects, with the consolidated balance sheet from which it has been derived.

Ernst + Young LLP

January 11, 2017

PART I. FINANCIAL INFORMATION

Item 1. *Financial Statements*

ASHTON WOODS USA L.L.C.
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)

	November 30, 2016	May 31, 2016
	(Unaudited)	
Assets:		
Cash and cash equivalents	\$ —	\$ —
Restricted cash	283	194
Receivables	12,630	17,125
Inventory	750,782	636,439
Real estate not owned	109,945	111,572
Property and equipment, net	24,980	27,277
Investments in unconsolidated entities	8,601	8,090
Deposits on real estate under option or contract	62,120	61,435
Other assets	21,413	23,931
Total assets	<u>\$ 990,754</u>	<u>\$ 886,063</u>
Liabilities and members' equity:		
Liabilities:		
Accounts payable	\$ 61,899	\$ 63,700
Other liabilities	42,514	47,559
Customer deposits	28,442	25,974
Liabilities related to real estate not owned	83,639	84,830
Debt	496,156	380,107
Total liabilities	<u>712,650</u>	<u>602,170</u>
Members' equity:	278,104	283,893
Total liabilities and members' equity	<u>\$ 990,754</u>	<u>\$ 886,063</u>

See accompanying notes to unaudited condensed consolidated financial statements.

ASHTON WOODS USA L.L.C.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(In thousands)

	Three months ended November 30,		Six months ended November 30,	
	2016	2015	2016	2015
	(Unaudited)			
Revenues:				
Home sales	\$ 276,994	\$ 244,717	\$ 490,646	\$ 449,461
Land sales	430	455	560	455
	<u>277,424</u>	<u>245,172</u>	<u>491,206</u>	<u>449,916</u>
Cost of sales:				
Cost of sales - homes	224,303	200,785	401,546	367,069
Cost of sales - land	459	455	587	455
	<u>224,762</u>	<u>201,240</u>	<u>402,133</u>	<u>367,524</u>
Gross profit	52,662	43,932	89,073	82,392
Other expense (income):				
Selling, general and administrative	37,656	34,282	71,941	66,982
Interest expense	3,115	2,794	6,245	5,836
Depreciation and amortization	3,696	3,346	7,057	6,406
Other income	(1,321)	(757)	(2,417)	(1,415)
	<u>43,146</u>	<u>39,665</u>	<u>82,826</u>	<u>77,809</u>
Equity in earnings in unconsolidated entities	146	346	263	647
Net income	<u>\$ 9,662</u>	<u>\$ 4,613</u>	<u>\$ 6,510</u>	<u>\$ 5,230</u>

See accompanying notes to unaudited condensed consolidated financial statements.

ASHTON WOODS USA L.L.C.
UNAUDITED CONDENSED CONSOLIDATED STATEMENT OF MEMBERS' EQUITY
(In thousands)

	Class A interest	Class B interests	Class C interests	Total members' equity
	(Unaudited)			
Members' equity at May 31, 2016	\$ 104,295	\$ 21,911	\$ 157,687	\$ 283,893
Net loss	(1,227)	(301)	(1,624)	(3,152)
Distributions	(3,603)	(885)	(4,770)	(9,258)
Members' equity at August 31, 2016	\$ 99,465	\$ 20,725	\$ 151,293	\$ 271,483
Net income	3,760	924	4,978	9,662
Distributions	(1,183)	(291)	(1,567)	(3,041)
Members' equity at November 30, 2016	\$ 102,042	\$ 21,358	\$ 154,704	\$ 278,104

See accompanying notes to unaudited condensed consolidated financial statements.

ASHTON WOODS USA L.L.C.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Six months ended November 30,	
	2016	2015
	(Unaudited)	
Cash flows from operating activities:		
Net income	\$ 6,510	\$ 5,230
Adjustments to reconcile net income to net cash used in operating activities:		
Equity in earnings in unconsolidated entities	(263)	(647)
Returns on investments in unconsolidated entities	172	501
Increase in liability for long-term compensation	624	669
Depreciation and amortization	7,057	6,406
Changes in operating assets and liabilities:		
Inventory	(108,502)	(117,602)
Receivables	4,495	2,694
Deposits on real estate under option or contract	(685)	3
Other assets	3,977	(637)
Accounts payable	(1,801)	16,370
Other liabilities	(5,793)	(6,254)
Customer deposits	2,468	9,304
Net cash used in operating activities	<u>(91,741)</u>	<u>(83,963)</u>
Cash flows from investing activities:		
Returns of investments in unconsolidated entities	439	1,385
Investments in unconsolidated entities	(735)	—
Additions to property and equipment	(4,778)	(7,080)
Changes in restricted cash	(89)	(1)
Net cash used in investing activities	<u>(5,163)</u>	<u>(5,696)</u>
Cash flows from financing activities:		
Borrowings from revolving credit facility	480,200	365,500
Repayments of revolving credit facility	(370,795)	(268,154)
Payments of debt issuance costs	(202)	(1,478)
Members' contributions	—	41
Members' distributions	(12,299)	(6,250)
Net cash provided by financing activities	<u>96,904</u>	<u>89,659</u>
Change in cash and cash equivalents	—	—
Cash and cash equivalents, beginning of period	<u>—</u>	<u>—</u>
Cash and cash equivalents, end of period	<u>\$ —</u>	<u>\$ —</u>
Supplemental cash flow information:		
Cash paid for interest, net of amounts capitalized	<u>\$ 5,752</u>	<u>\$ 5,502</u>
Supplemental disclosure of non-cash financing activity:		
Issuance of loan upon real estate acquisition	<u>\$ 5,841</u>	<u>\$ 2,338</u>

See accompanying notes to unaudited condensed consolidated financial statements.

ASHTON WOODS USA L.L.C.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
November 30, 2016

Note 1 — Basis of Presentation and Significant Accounting Policies

(a) Operations

Ashton Woods USA L.L.C. (the "Company" or "Ashton Woods"), operating as Ashton Woods Homes, is a limited liability company that designs, builds and markets attached and detached single-family homes under the Ashton Woods Homes and Starlight Homes brand names. The Company has operations in the following markets:

East: Raleigh, Charleston, Atlanta, Orlando, and Southwest Florida (Tampa, Sarasota and Naples)
Central: Houston, Dallas, Austin, San Antonio, and Phoenix

In addition, the Company offers title services to its homebuyers in its Dallas, San Antonio, Orlando, Southwest Florida, Raleigh, and Atlanta operating divisions through two wholly-owned title agencies and offers title services to its homebuyers in its Austin and Houston operating divisions through ownership in a title joint venture. The Company has an ownership interest of 49% in the joint venture, which is managed by the majority owner with whom the underwriting risks associated with the title insurance reside. A second joint venture that offered title services to the Company's homebuyers in Dallas and San Antonio has discontinued its operations.

(b) Basis of presentation

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned, majority-owned and controlled subsidiaries. All intercompany balances and transactions have been eliminated in consolidation. In the Company's opinion, all adjustments (consisting solely of normal recurring accruals) necessary for a fair presentation of the results for the interim periods presented have been included in the accompanying unaudited condensed consolidated financial statements.

(c) Cash and cash equivalents

The Company considers all highly liquid investments with an initial maturity of three months or less when purchased to be cash equivalents.

(d) Inventory

In addition to the costs of direct land acquisition, land development and home construction, inventory costs include interest, real estate taxes and indirect overhead costs incurred during development and home construction. The Company uses the specific identification method for the purpose of accumulating home construction costs. Cost of sales for homes closed includes the specific construction costs of each home (both incurred and estimated to be incurred) and all applicable land acquisition, land development and related costs based upon the total number of homes expected to be closed in each community. Any changes to the estimated total development costs subsequent to the initial home closings in a community are allocated to the remaining homes in the community.

When a home is closed, the Company generally has not yet recorded all incurred costs necessary to complete the home. Each month, the Company records as a liability and a charge to cost of sales the amount it estimates will ultimately be paid related to completed homes that have been closed as of the end of that month. The Company compares its updated home construction budgets to actual recorded costs to estimate the additional costs remaining to be paid on each closed home. The Company monitors the accuracy of each month's accrual by comparing actual costs paid on closed homes in subsequent months to the amount accrued. Actual costs to be paid on closed homes in the future could differ from the current estimate.

Inventory is stated at cost, unless the carrying amount is determined not to be recoverable, in which case the inventory is written down to fair value in accordance with the Financial Accounting Standards Board ("FASB") Accounting Standard Codification ("ASC") Subtopic 360-10, *Property, Plant and Equipment*. The Company reviews its inventory in accordance with ASC Subtopic 360-10, which requires long-lived assets to be assessed for impairment when facts

and circumstances indicate an impairment may exist. The Company utilizes an undiscounted future cash flow model in this assessment. When the results of the undiscounted future cash flows are less than the carrying value of the community (asset group), an asset impairment must be recognized in the consolidated financial statements as a component of cost of sales. The amount of the impairment is calculated by subtracting the estimated fair value, less cost to sell, of the community from the carrying value. ASC Subtopic 360-10 also requires that assets held for sale be stated at the lower of cost or fair value less costs to sell. Accordingly, land held for sale is stated at the lower of accumulated cost or fair value less costs to sell.

In order for management to assess the fair value of its real estate assets, certain assumptions must be made that are highly subjective and susceptible to change. Management evaluates, among other things, the actual gross margins for homes closed and the gross margins for homes sold in backlog (representing the number or value of sales that have not yet closed, net of cancellations). This evaluation also includes assumptions with respect to future home sales prices, cost of sales, including levels of sales incentives, the monthly rate of sales, discount rates, profit margins, and potential buyers, which are critical in determining the fair value of the Company's real estate assets. If events and circumstances indicate that the carrying value of a real estate asset is not expected to be recoverable, then it is written down to its estimated fair value. Given the historical variability in the homebuilding industry cycle, the Company is of the view that the valuation of homebuilding inventories is sensitive to changes in economic conditions, such as interest rates, the availability of credit and unemployment levels. Changes in these economic conditions could materially affect the projected home sales prices, the level of sales incentives, the costs to develop land and construct homes and the monthly rate of sales. Because of these potential changes in economic and market conditions, in conjunction with the assumptions and estimates required of management in valuing homebuilding inventory, actual results could differ materially from management's assumptions and may require material inventory impairments to be recorded in the future.

(e) Receivables

Receivables at November 30, 2016 and May 31, 2016 consisted of the following (in thousands):

	November 30, 2016	May 31, 2016
Closing funds due	\$ 1,380	\$ 6,285
Land development receivables	6,287	5,307
MUD receivables ⁽¹⁾	3,495	3,456
Other receivables ⁽²⁾	1,468	2,077
	<u>\$ 12,630</u>	<u>\$ 17,125</u>

(1) Includes certain land development costs to be reimbursed by three Municipal Utility Districts in Houston, Texas.

(2) Includes amounts due from utility companies, insurance companies, escrow deposits, and drawn amounts due from salespersons.

(f) Real estate not owned

Real estate not owned reflects the future purchase price of lots under option purchase agreements with entities under common control or with third parties pursuant to (depending on the circumstances) ASC Subtopic 360-20, *Property, Plant and Equipment – Real Estate Sales*, ASC Subtopic 470-40, *Product Financing Arrangements*, or ASC Subtopic 810, *Consolidation* (see Note 4).

(g) Investments in unconsolidated entities

The Company participates in three land development joint ventures in which it has less than a controlling interest. The Company accounts for its interests in these entities under the equity method. The Company's share of profits from lots it purchases from these entities is deferred and treated as a reduction of the cost basis of land purchased from the entity. The Company's share of profits from lots purchased by third parties is recognized immediately and included within equity in earnings in unconsolidated entities in the consolidated statements of income (see Note 6).

The Company offers title services to its homebuyers in its Dallas, San Antonio, Orlando, Southwest Florida, Raleigh, and Atlanta operating divisions through two wholly-owned title agencies and offers title services to its homebuyers in its Austin and Houston operating divisions through ownership in a title joint venture. The Company has an ownership interest of 49% in the joint venture, which is managed by the majority owner with whom the underwriting risks associated

with the title insurance reside. A second joint venture that offered title services to the Company's homebuyers in Dallas and San Antonio has discontinued its operations. The Company's investments in these two title service joint ventures are accounted for under the equity method.

Investments in unconsolidated entities are evaluated for other-than-temporary impairment during each reporting period pursuant to ASC Subtopic 323-10, *Investments—Equity Method and Joint Ventures*. A series of operating losses or other factors may indicate an other-than-temporary decrease in the value of the Company's investment in the unconsolidated entity. The amount of impairment recognized is the excess of the investment's carrying value over its estimated fair value.

(h) Deposits and pre-acquisition costs

Deposits and pre-acquisition costs related to purchase agreements are capitalized when paid and classified in the consolidated balance sheets as deposits on real estate under option contract (for deposits) and other assets (for pre-acquisition costs) until the related land is acquired. These costs are transferred to inventory at the time the land or lots are acquired. Nonrefundable deposits and pre-acquisition costs are charged to expense when the real estate purchase is no longer considered probable. If the Company intends to terminate a purchase agreement, it records a charge to earnings for these costs associated with the purchase agreement in the period such a decision is made. This expense is included as a component of cost of sales – homes in the consolidated statements of income and was \$0.2 million and \$0.1 million for the three months ended November 30, 2016 and 2015, respectively, and \$0.6 million and \$0.2 million for the six months ended November 30, 2016 and 2015, respectively.

(i) Property and equipment

Property and equipment is recorded at cost. Depreciation is generally recorded using the straight-line method over the estimated useful lives of the assets, which range from two to five years. Depreciable lives for leasehold improvements reflect the lesser of the economic life of the asset or the life of the lease. Repairs and maintenance costs are expensed as incurred. The Company's property and equipment at November 30, 2016 and May 31, 2016 consisted of the following (in thousands):

	November 30, 2016	May 31, 2016
Office furniture and equipment	\$ 3,891	\$ 3,888
Sales offices, design studios and model furnishings	46,989	44,739
Leasehold improvements	1,859	1,972
	<u>52,739</u>	<u>50,599</u>
Accumulated depreciation and amortization ⁽¹⁾	(27,759)	(23,322)
	<u>\$ 24,980</u>	<u>\$ 27,277</u>

(1) Net of retirements and disposals.

Depreciation and amortization expense approximated \$3.7 million and \$3.3 million for the three months ended November 30, 2016 and 2015, respectively, and \$7.1 million and \$6.4 million for the six months ended November 30, 2016 and 2015, respectively.

(j) Revenue recognition

Revenues from homebuilding and land sales are recognized at the time of the closing of each sale, when title to and possession of the property are transferred to the buyer. Internal and external sales commissions are included in selling, general and administrative expenses in the consolidated statement of income. Typically, all homebuilding and land net sales proceeds are received in cash within two business days of closing.

(k) Prepaid expenses

Included in other assets are prepaid expenses of approximately \$7.1 million and \$8.8 million as of November 30, 2016 and May 31, 2016, respectively, which primarily represent prepaid insurance, fees, permits, and rent.

(l) Warranty costs

The Company provides its homebuyers with limited warranties that generally provide for ten years of structural coverage, two years of coverage for plumbing, electrical and heating, ventilation and air conditioning systems and one year of coverage for workmanship and materials. Warranty liabilities are initially established on a per home basis by charging cost of sales and establishing a warranty liability for each home delivered to cover expected costs of materials and labor during the warranty period. The amounts accrued are based on management's estimate of expected warranty-related costs under all unexpired warranty obligation periods. The Company's warranty liability is based upon historical warranty cost experience in each operating division and is adjusted as appropriate to reflect qualitative risks associated with the types of homes built and the geographic areas in which they are built. The Company's warranty liability is included in other liabilities in the consolidated balance sheets.

Presented below are summaries of the activity in the Company's warranty liability account for the three and six months ended November 30, 2016 and 2015 (in thousands):

	Three months ended November 30,		Six months ended November 30,	
	2016	2015	2016	2015
Warranty liability, beginning of period	\$ 8,887	\$ 6,340	\$ 9,431	\$ 7,032
Costs accrued during period	2,021	2,308	4,179	4,059
Costs incurred during period	(2,511)	(2,325)	(5,213)	(4,768)
Warranty liability, end of period	<u>\$ 8,397</u>	<u>\$ 6,323</u>	<u>\$ 8,397</u>	<u>\$ 6,323</u>

(m) Advertising costs

The Company expenses advertising costs as they are incurred. Advertising expense, which is included in selling, general and administrative expenses in the consolidated statements of income, was approximately \$1.5 million and \$1.6 million for the three months ended November 30, 2016 and 2015, respectively, and \$3.1 million and \$3.3 million for the six months ended November 30, 2016 and 2015, respectively.

(n) Long-term incentive plan

The Company offers a long-term incentive compensation program designed to align the interests of the Company and its executives by enabling key employees to participate in the Company's future growth through the issuance of performance shares, which are the equivalent of phantom equity awards. The Company's performance shares issued prior to June 1, 2016 are accounted for pursuant to ASC Subtopic 718-30, *Compensation – Awards Classified as Liabilities*, as the value of such shares is based, in part, on the price of the shares of a comparable set of public builders. The Company's performance shares issued on or after June 1, 2016 are accounted for pursuant to ASC Subtopic 710-10-25-9 to 25-11, *Deferred Compensation Arrangements*, as the value is not based on the shares of a comparable set of public builders or other equity instruments, but is based on the book value of equity of the Company. The Company measures the value of the performance shares issued prior to June 1, 2016 on a quarterly basis using the intrinsic value method, and measures the value of the performance shares issued on or after June 1, 2016 on a quarterly basis based on the value of the future expected payments to be made. Additional compensation expense may be recognized subsequent to completion of the vesting period for appreciation-only performance shares. See Note 11 for additional discussion regarding the Company's long-term incentive plan.

(o) Income taxes

The Company operates as a limited liability company and is treated as a partnership for income tax purposes. Accordingly, the Company incurs no liability for federal or state income taxes, since the taxable income or loss is passed through to its Members, but incurs liabilities for certain state taxes payable directly by the Company. The Company calculates its Members' potential tax liability related to their share of the Company's taxable income and may make distributions to such Members to allow them to satisfy their tax liability, subject to limitations contained in the Company's senior secured revolving credit facility and in the indenture governing its 6.875% Senior Notes due 2021 (the "6.875% Notes"). Any tax distributions made to the Members are treated as a reduction of equity. The Company made distributions of \$12.3 million and \$6.3 million during the six months ended November 30, 2016 and 2015, respectively.

(p) Use of estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States (“GAAP”) requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

(q) Segments

ASC Subtopic 280, *Segment Reporting* (“ASC 280”) provides standards for the way in which companies report information about operating segments. In accordance with ASC 280, the Company believes that each of its homebuilding operating markets is an operating segment. In accordance with the aggregation criteria defined in ASC 280, the Company has grouped its homebuilding operations into two reportable segments as follows:

- 1) East: Raleigh, Charleston, Atlanta, Orlando, and Southwest Florida (Tampa, Sarasota and Naples)
- 2) Central: Houston, Dallas, Austin, San Antonio, and Phoenix

The Company has determined that the homebuilding operating markets within its respective reportable segments have similar economic characteristics and product types, and are similar in terms of geography. The Company’s homebuilding operating markets also share all other relevant aggregation characteristics prescribed in ASC 280, such as similar product types, production processes and methods of distribution. See Note 14 for further discussion of the Company’s reportable segments.

(r) Subsequent events

The Company has evaluated subsequent events through January 11, 2017. This date represents the date on which the condensed consolidated financial statements were available to be issued.

Note 2 — Pending and Recently Adopted Accounting Pronouncements

In May 2014, the FASB issued Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers* (“ASU 2014-09”). ASU 2014-09 states that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The allowable methods of adoption are full retrospective adoption or modified retrospective adoption. In August 2015, the FASB issued Accounting Standards Update No. 2015-14, *Revenue from Contracts with Customers: Deferral of the Effective Date* (“ASU 2015-14”), which defers the effective date by one year while providing the option to early adopt the standard on the original effective date. Accordingly, the effective date for ASU 2015-14 for the Company is for annual periods beginning after December 15, 2018 and interim periods within annual periods beginning after December 15, 2019. The Company is currently evaluating the impact that ASU 2014-09 will have on its consolidated financial statements and related disclosures.

In August 2014, the FASB issued Accounting Standards Update No. 2014-15, *Disclosure of Uncertainties About an Entity’s Ability to Continue as a Going Concern* (“ASU 2014-15”), which requires management to perform interim and annual assessments on whether there are conditions or events that raise substantial doubt about the entity’s ability to continue as a going concern within one year of the date the financial statements are issued and to provide related disclosures, if required. The amendments in ASU 2014-15 are effective for the annual period ending after December 15, 2016, and for annual and interim periods thereafter. Early adoption is permitted. The Company’s adoption of ASU 2014-15 is not expected to have a material effect on its consolidated financial statements and related disclosures.

In February 2015, the FASB issued Accounting Standards Update No. 2015-02, *Amendments to the Consolidation Analysis* (“ASU 2015-02”), which changed the analysis a reporting entity must perform to determine whether it should consolidate certain types of legal entities. The amendments in ASU 2015-02 affect reporting entities that are required to evaluate whether they should consolidate certain legal entities. All legal entities are subject to reevaluation under the revised consolidation model. The amendments in ASU 2015-02 are effective for annual periods ending after December 15, 2016, and for annual and interim periods thereafter. Early adoption is permitted. The Company’s adoption of ASU 2015-02 is not expected to have a material effect on its consolidated financial statements and related disclosures.

In April 2015, the FASB issued Accounting Standards Update No. 2015-03, *Interest - Imputation of Interest* ("ASU 2015-03"), which requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. Prior to the issuance of ASU 2015-03, debt issuance costs were presented as deferred charge assets, separate from the related debt liability. ASU 2015-03 does not change the recognition and measurement requirements for debt issuance costs. The Company early-adopted ASU 2015-03 as of the end of its fiscal year ended May 31, 2016, and applied its provisions retrospectively. The adoption of ASU 2015-03 did not have an impact on the Company's consolidated financial statements and related disclosures. The Company has elected to continue to present the debt issuance costs related to the Restated Revolver as deferred charge assets in other assets (see Note 5).

In January 2016, the FASB issued Accounting Standards Update No. 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities* ("ASU 2016-01"), which updates certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The effective date for ASU 2016-01 for the Company is for annual periods beginning after December 15, 2019. The Company is currently evaluating the impact that ASU 2016-01 will have on its consolidated financial statements and related disclosures.

In February 2016, the FASB issued Accounting Standards Update No. 2016-02, *Leases* ("ASU 2016-02"), which requires, among other things, that lessees recognize the assets and liabilities arising from operating leases on the balance sheet. The effective date of ASU 2016-02 for the Company is for annual periods beginning after December 15, 2019, and for annual and interim periods thereafter. The Company is currently evaluating the impact that ASU 2016-02 will have on its consolidated financial statements and related disclosures.

In March 2016, the FASB issued Accounting Standards Update No. 2016-07, *Investments - Equity Method and Joint Ventures* ("ASU 2016-07"), which eliminates the requirement to apply the equity method of accounting retrospectively when a reporting entity obtains significant influence over a previously held investment. The effective date of ASU 2016-07 for the Company is for annual and interim periods beginning after December 15, 2016. The Company's adoption of ASU 2016-07 is not expected to have a material effect on its consolidated financial statements and related disclosures.

In March 2016, the FASB issued Accounting Standards Update No. 2016-09, *Compensation - Stock Compensation (Topic 718)* ("ASU 2016-09"), which simplifies several aspects related to the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification in the statement of cash flows. The effective date of ASU 2016-09 for the Company is for annual periods beginning after December 15, 2017. The Company is currently evaluating the impact that ASU 2016-09 will have on its consolidated financial statements and related disclosures.

In August 2016, the FASB issued Accounting Standards Update No. 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments* ("ASU 2016-15"), which addresses several specific cash flow issues. The effective date of ASU 2016-15 for the Company is for annual and interim periods beginning after January 1, 2018, with early adoption permitted, and requires full retrospective application on adoption. The Company's adoption of ASU 2016-15 is not expected to have a material effect on its consolidated financial statements and related disclosures.

In October 2016, the FASB issued Accounting Standards Update No. 2016-17, *Consolidation (Topic 810): Interests Held through Related Parties That Are under Common Control* ("ASU 2016-17") which amends the consolidation guidance on how a reporting entity that is the single decision maker of a variable interest entity ("VIE") should treat indirect interests in the entity held through related parties that are under common control with the reporting entity when determining whether it is the primary beneficiary of that VIE. The effective date of ASU 2016-17 for the Company is for fiscal years beginning after December 2016, with early adoption permitted. The Company is currently evaluating the impact that ASU 2016-17 will have on its consolidated financial statements and related disclosures.

On November 17, 2016, the FASB issued Accounting Standards Update No. 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash* ("ASU 2016-18"), which provides specific guidance on the cash flow classification and presentation of changes in restricted cash and restricted cash equivalents. The effective date of ASU 2016-18 for the Company is for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years, with early adoption permitted. The Company is currently evaluating the impact that ASU 2016-18 will have on its consolidated financial statements and related disclosures.

Note 3 — Inventory

Inventory consisted of the following at November 30, 2016 and May 31, 2016 (in thousands):

	November 30, 2016	May 31, 2016
Homes under construction and finished homes	\$ 447,359	\$ 364,932
Finished lots	246,955	231,861
Land under development	34,390	26,455
Land held for sale	3,790	5,796
Land held for future development	18,278	6,093
Commercial land	10	1,302
	<u>\$ 750,782</u>	<u>\$ 636,439</u>

The Company owns commercial land in Dallas with a book value of \$1.3 million at both November 30, 2016 and May 31, 2016. The Company is actively marketing the land and meets all the conditions necessary for accounting for such land as held for sale and therefore has classified the commercial land as land held for sale in inventory on the November 30, 2016 unaudited condensed consolidated balance sheet. The land was classified as commercial land on the May 31, 2016 consolidated balance sheet.

The Company capitalizes all interest incurred to the extent its qualifying assets exceed its debt obligations. If qualifying assets are less than the Company's debt obligations, there are limits on the amount of interest that can be capitalized, and the remainder of interest incurred must be directly expensed. The Company directly expensed interest of \$3.1 million and \$2.8 million for the three months ended November 30, 2016 and 2015, respectively, and \$6.2 million and \$5.8 million for the six months ended November 30, 2016 and 2015, respectively, in the condensed consolidated statements of income.

The following table summarizes interest costs incurred, charged to cost of sales and directly expensed during the three and six months ended November 30, 2016 and 2015 (in thousands):

	Three months ended November 30,		Six months ended November 30,	
	2016	2015	2016	2015
Capitalized interest, beginning of period	\$ 11,310	\$ 10,215	\$ 9,951	\$ 10,241
Interest incurred	8,753	7,971	17,127	15,370
Interest amortized to cost of sales	(4,968)	(4,372)	(8,853)	(8,755)
Interest expensed	(3,115)	(2,794)	(6,245)	(5,836)
Capitalized interest, end of period	<u>\$ 11,980</u>	<u>\$ 11,020</u>	<u>\$ 11,980</u>	<u>\$ 11,020</u>

Note 4 — Real Estate Not Owned

In the ordinary course of business, the Company enters into lot purchase agreements in order to procure lots for the construction of homes in the future. Pursuant to these lot purchase agreements, the Company generally will provide a deposit to the seller as consideration for the right, but not the obligation, to purchase lots at different times in the future, usually at predetermined prices. Depending on the circumstances of such lot purchase agreements, "Real estate not owned" may be recorded based on the application of different accounting provisions. In applying these provisions, the Company regularly evaluates its land and lot purchase agreements.

Pursuant to ASC Subtopic 810, *Consolidations* ("ASC 810"), when the Company enters into a purchase agreement to acquire land or lots from an entity and pays a non-refundable deposit, the Company has concluded that a VIE, for which consolidation is required, may be created because it is deemed to have provided subordinated financial support that will absorb some or all of an entity's expected losses if they occur. For each VIE, the Company assesses whether it is the primary beneficiary of the VIE and thus must consolidate the entity by first determining if it has the ability to control the activities of the VIE that most significantly impact its economic performance. Such activities include, but are not limited to, the ability to determine the budget and scope of land development work, if any; the ability to control

financing decisions for the VIE; the ability to acquire additional land into the VIE or dispose of land in the VIE not under contract; and the ability to change or amend the existing purchase contract with the VIE. If the Company is determined not to control such activities, it is not considered the primary beneficiary of the VIE. If it does have the ability to control such activities, it will continue the analysis by determining if it is expected to absorb a potentially significant amount of the VIE's losses or, if no party absorbs the majority of such losses, if it will benefit from potentially a significant amount of the VIE's expected gain. If the Company determines that it is the primary beneficiary of the VIE, it will consolidate the VIE in its financial statements and reflect such assets as "Real estate not owned" and the related liabilities as "Liabilities related to real estate not owned." At November 30, 2016 and May 31, 2016, no purchase contracts or investments in unconsolidated entities were determined to require consolidation under ASC 810.

Based on the provisions of ASC Subtopic 360-20, *Property, Plant, and Equipment*, a seller may not recognize as a sale property it sells if there continues to be substantial continuing involvement with the property. If the Company enters into lot purchase agreements for land it has sold and determines that there is substantial continuing involvement at the reporting date, the Company records the lots subject to such sale as "Real Estate not owned" and the related liabilities as "Liabilities related to real estate not owned." At November 30, 2016 and May 31, 2016, the Company recorded real estate not owned of \$18.1 million and \$11.6 million, respectively, for the sale of lots because of its continuing involvement.

Pursuant to ASC Subtopic 470-40, *Product Financing Arrangements* ("ASC 470-40"), if a buying entity participates in an arrangement in which it is economically compelled to purchase land, then the entity is required to consolidate such an arrangement. From time to time, the Company enters into arrangements in which it locates lots that it desires to purchase, finds an investor to purchase the lots and then enters into option purchase agreements to acquire the lots in staged takedowns. In consideration for such options, the Company generally makes nonrefundable deposits. The Company is generally not obligated to purchase the lots that are the subject of such agreements, but it would forfeit the remaining deposits if the lots are not purchased. Although the Company is not obligated to purchase the lots under option unless it enters into a contract with specific performance obligations, if, at the reporting date, it believes that due to the terms of the purchase contracts it is compelled to purchase the lots under option, the Company will record "Real estate not owned" and the related liabilities as "Liabilities related to real estate not owned" in connection with such option purchase agreements. The Company has entered into three lot purchase agreements with two separate unaffiliated investor groups and has accounted for them pursuant to ASC 470-40. At November 30, 2016 and May 31, 2016, the Company recorded real estate not owned of \$91.8 million and \$100.0 million, respectively, related to the lot purchase agreements accounted for pursuant to ASC 470-40.

Note 5 — Other Assets

Other assets at November 30, 2016 and May 31, 2016 consisted of the following (in thousands):

	November 30, 2016	May 31, 2016
Architecture plans	\$ 9,190	\$ 9,469
Prepaid expenses	7,054	8,754
Deferred financing fees	2,996	3,503
Pre-acquisition costs	1,179	1,148
Other deposits	994	1,057
	<u>\$ 21,413</u>	<u>\$ 23,931</u>

Architecture plans are comprised of the costs incurred related to architecture plans, associated engineering costs, and interactive floor plans for house plans and are amortized through cost of sales on a per closing basis.

See Note 1(h) for additional information on pre-acquisition costs.

Deferred financing fees included in other assets are comprised of costs incurred in connection with obtaining financing for the senior secured revolving credit facility. The deferred financing fees related to the senior secured revolving credit facility have not been reclassified to long-term debt in accordance with the Company's adoption of ASU 2015-03 (see Note 2). Deferred financing fees are amortized as interest over the terms of the related financing arrangement using the effective interest method. The Company incurred deferred financing fees during the six months ended November 30, 2016 of \$0.2 million as a result of the Company partially exercising the accordion feature under

the Company's senior secured revolving credit facility to increase the total commitments, and incurred \$1.5 million during the six months ended November 30, 2015 as a result of amendments to the Company's senior secured revolving credit facility.

Note 6 — Investments in Unconsolidated Entities

The Company enters into land joint ventures from time to time as a means of accessing larger parcels of land and lot positions, managing its risk profile and leveraging its capital base. As of November 30, 2016, the Company participated in three such land joint ventures. The Company's partners in such joint ventures are both related parties and unrelated parties, including homebuilders, land developers or other real estate entities. The partners generally share profits and losses in accordance with their ownership interests. The Company accounts for its interests in these entities under the equity method.

As of November 30, 2016, the Company had equity investments of less than 50% in each of its three land joint ventures and did not have a controlling interest in these unconsolidated entities. The Company and/or its land joint venture partners will typically enter into lot purchase agreements that permit the Company and/or its joint venture partners to purchase finished lots owned by the land joint venture. Lot prices are generally negotiated prices that approximate fair value when the purchase contract is signed. The Company's share of the unconsolidated entity's earnings on the sale of lots to the Company is deferred until homes related to the lots purchased by the Company are delivered and title passes to a homebuyer. The Company's share of the unconsolidated entity's earnings on the sale of lots to other parties is recognized at the time of the sale.

One of the Company's land joint ventures was entered into with an affiliate of certain of the beneficial owners of the Company's equity or their affiliates (individually and collectively, the "Investors"). The Company has a 49% limited partner interest in this joint venture that is accounted for under the equity method. As of November 30, 2016, the Company had recorded \$7.4 million for its investment in this unconsolidated entity in the condensed consolidated balance sheet. The Company entered into a services agreement with the joint venture to provide accounting and administrative services to the joint venture. The Company receives a monthly fee of \$6,000 for these services that is included in other income in the consolidated statements of income. The Company is a party to a lot purchase agreement with the joint venture, which required a 10% deposit, and has no specific performance requirements for the Company. As of November 30, 2016, the total purchase price of lots remaining to be purchased under this agreement was approximately \$11.5 million. As of November 30, 2016, the joint venture had debt outstanding of \$6.4 million, which is non-recourse to the joint venture and to the Company. The loan was obtained to acquire the land and fund the first phase of land development. The Company provided the lender with a performance guarantee for the substantial completion of the first phase of development for this joint venture. The guarantee of performance may include the payment of money for costs incurred during the completion of the development. In the event that the Company pays money or performs any services pursuant to the guarantee, the joint venture has agreed to indemnify and reimburse the Company for any such costs incurred.

The Company offers title services to its homebuyers in its Dallas, San Antonio, Orlando, Southwest Florida, Raleigh, and Atlanta operating divisions through two wholly-owned title agencies and offers title services to its homebuyers in its Austin and Houston operating divisions through ownership in a title joint venture. The Company has an ownership interest of 49% in the joint venture, which is managed by the majority owner with whom the underwriting risks associated with the title insurance reside. A second joint venture that offered title services to the Company's homebuyers in Dallas and San Antonio has discontinued its operations.

Summarized unaudited financial information related to unconsolidated entities that are accounted for using the equity method as of November 30, 2016 and May 31, 2016 and for the three and six months ended November 30, 2016 and 2015 was as follows (in thousands):

	November 30, 2016	May 31, 2016
Assets:	(Unaudited)	
Cash	\$ 741	\$ 2,220
Real estate	25,490	29,790
Other	198	201
Total assets	<u>\$ 26,429</u>	<u>\$ 32,211</u>
Liabilities:		
Liabilities:		
Accounts payable and other accruals	\$ 2,714	\$ 3,080
Notes payable	6,386	10,731
Total liabilities	<u>9,100</u>	<u>13,811</u>
Equity	17,329	18,400
Total liabilities and equity	<u>\$ 26,429</u>	<u>\$ 32,211</u>

	Three months ended November 30,		Six months ended November 30,	
	2016	2015	2016	2015
	(Unaudited)			
Revenues	\$ 3,103	\$ 4,918	\$ 7,102	\$ 6,529
Gross profit	663	2,012	1,437	3,068
Operating expenses	223	266	398	466
Net earnings	441	1,746	1,039	2,749

Note 7 — Debt

Debt at November 30, 2016 and May 31, 2016 consisted of the following (in thousands):

	November 30, 2016	May 31, 2016
6.875% Notes ⁽¹⁾	\$ 343,774	\$ 342,971
Senior secured revolving credit facility	144,203	34,798
Notes payable	8,179	2,338
	<u>\$ 496,156</u>	<u>\$ 380,107</u>

(1) Net of \$4.3 million and \$4.9 million, respectively, of unamortized deferred financing fees as of November 30, 2016 and May 31, 2016.

The 6.875% Notes

The Company has issued and outstanding \$350 million principal amount of 6.875% Senior Notes due 2021 (the "6.875% Notes"). The 6.875% Notes mature February 15, 2021.

Interest is payable on the 6.875% Notes on February 15 and August 15 of each year. The 6.875% Notes are senior, unsecured obligations of the Company and rank equally in right of payment to all of the Company's existing and future senior debt and senior in right of payment to the Company's existing and future subordinated debt. The 6.875% Notes are effectively subordinated to any of the Company's existing and future secured debt, including the Company's senior secured revolving credit facility, to the extent of the value of the assets securing such debt. The obligations under the 6.875% Notes are jointly and severally guaranteed by each Restricted Subsidiary, as defined, that has assets with a book value of more than \$2.0 million.

The Company has the option to redeem the 6.875% Notes at any time or from time to time, in whole or in part, (a) until February 15, 2017, at a redemption price equal to 100% of their principal amount, together with accrued and unpaid interest thereon, if any, to and excluding the redemption date, plus a make-whole premium as defined in the indenture governing the 6.875% Notes, (b) on or after February 15, 2017, at certain redemption prices set forth in the indenture governing the 6.875% Notes together with accrued and unpaid interest thereon, if any, to and excluding the redemption date, and (c) on or after February 15, 2019, at 100% of the principal amount to be redeemed, together with accrued and unpaid interest thereon, if any, to and excluding the redemption date.

The indenture governing the 6.875% Notes contains a number of covenants, including covenants relating to the following:

- Limitations on indebtedness;
- Limitations on restricted payments;
- Limitations on dividends;
- Limitations on transactions with affiliates;
- Limitations on liens;
- Limitations on asset sales;
- Limitations on designation of unrestricted subsidiaries; and
- Limitations on mergers.

As of November 30, 2016, the Company was in compliance with the covenants in the indenture governing the 6.875% Notes.

Senior Secured Revolving Credit Facility

On July 31, 2015, the Company amended its senior secured revolving credit facility by entering into a Fifth Amended and Restated Credit Agreement (the "Restated Revolver"), providing for, among other things, (i) an initial aggregate revolving loan commitment of up to \$260.0 million, with an accordion feature to permit the size of the facility to be increased in the future up to \$300 million (dependent upon Company needs and available lender commitments), of which up to \$45.0 million is available for the issuance of letters of credit and up to \$10 million is available for a swingline facility, and (ii) a maturity date of January 31, 2019. The Restated Revolver limits the principal amount of the aggregate commitment available to the amount that is supported by the permitted lien basket in the indenture governing the Company's 6.875% Notes, which is 30% of Consolidated Tangible Assets, as defined therein ("CTA"), which resulted in an aggregate commitment of \$217.0 million at July 31, 2015. On October 14, 2015, the aggregate available commitment was increased to \$231.0 million and on January 13, 2016, the aggregate available commitment was increased to \$255.0 million based on CTA as of August 31, 2015 and November 30, 2015, respectively, pursuant to the terms of the Restated Revolver. On May 24, 2016, the Company partially exercised the accordion feature under the Restated Revolver to increase the total commitments from \$255 million to \$285 million. No other modifications have been made to the terms, conditions or covenants of the Restated Revolver.

Interest accrues on borrowings under the Restated Revolver at the London Interbank Offered Rate (LIBOR) plus an applicable margin that ranges from 315 to 385 basis points. Letters of credit may be issued under the Restated Revolver at a rate of 100 basis points if secured by cash, or at a rate of 315 to 385 basis points if not secured by cash. The Restated Revolver has a maturity date of January 31, 2019, subject to an extension in accordance with the terms set forth therein. The Restated Revolver is secured by a continuing first priority security interest in the real property of certain operating divisions selected by the Company for inclusion in the borrowing base, and the personal property of the Company and its subsidiaries affixed to, placed upon, used in connection with, arising from or appropriated for use on the pledged real property and the continuing guarantee of substantially all of its subsidiaries. The Company may pledge additional collateral as needed to increase the borrowing base consistent with the maximum availability under the Restated Revolver.

The Restated Revolver contains the following material financial covenants:

- A minimum level of Tangible Net Worth;
- A maximum Leverage Ratio;
- A minimum Interest Coverage Ratio;
- Minimum liquidity;
- Maximum level of land supply; and
- Maximum level of Speculative Housing Units and Model Housing Units.

Availability under the Restated Revolver is based upon a borrowing base formula. Additionally, the Restated Revolver contains covenants in addition to the financial covenants noted above. The Restated Revolver permits sales and transfers of ownership interests in the Company so long as no change of control, as defined in the Restated Revolver, occurs and permits certain tax distributions to Members and permits certain other distributions to Members if certain Leverage Ratio and other conditions are met. As of November 30, 2016, the Company was in compliance with the covenants in the Restated Revolver.

At November 30, 2016, there was \$144.2 million outstanding under the Restated Revolver and \$6.2 million of letters of credit outstanding. As of November 30, 2016, and subject to a borrowing base formula, the Company had available additional borrowing capacity of \$132.1 million under the Restated Revolver based on outstanding borrowings on the Restated Revolver, outstanding letters of credit, and the value of collateral pledged to secure the facility.

Notes Payable

On November 19, 2015, the Company issued a \$2.3 million note payable to an unaffiliated third party which matures on November 19, 2017. The non-interest bearing note is collateralized by the land to which it relates and has no recourse to any other assets or the Company. At November 30, 2016, the outstanding note payable balance totaled \$2.3 million.

On September 23, 2016, the Company issued a \$5.8 million note payable to an unaffiliated third party which has an interest rate of 1.00% and matures on September 23, 2017. The note is collateralized by the land to which it relates and has no recourse to any other assets or the Company. At November 30, 2016, the outstanding note payable balance totaled \$5.8 million.

Note 8 — Other Liabilities

Other liabilities at November 30, 2016 and May 31, 2016 consisted of the following (in thousands):

	November 30, 2016	May 31, 2016
Salaries, bonuses and benefits	\$ 10,193	\$ 16,087
Accrued interest	7,808	7,566
Warranty accruals	8,397	9,431
Accrued long-term compensation	2,450	3,095
Other	13,666	11,380
	<u>\$ 42,514</u>	<u>\$ 47,559</u>

Note 9 — Members' Equity, Amended Regulations, and Ownership

The Second Amended and Restated Regulations (as amended, the "Regulations") of Ashton Woods created three classes of members and associated membership interests as follows: (1) Class A Membership Interest, which is held by Little Shots Nevada, L.L.C. ("Little Shots"), (2) Class B Membership Interests initially issued to the holders of our former 11.0% Senior Subordinated Notes due 2015, the majority of which are now held by Little Shots, and (3) Class C Membership Interests created in June 2010, the majority of which are held by Little Shots. The Regulations set forth each Member's respective membership interests and sharing ratio. No Member is required to make any additional contributions to the Company. Subject to certain limited exceptions, including for tax distributions, all items of income, gain, loss, deduction and credit of Ashton Woods will be allocated among the Members in accordance with their sharing ratios.

At November 30, 2016, there were 20,628,729 membership interests outstanding, comprised as follows:

	Membership Interests	Ownership percentage	Percentage of membership class
Little Shots Nevada L.L.C.			
Class A	8,027,200	38.91%	100.00%
Class B	1,918,979	9.31%	97.27%
Class C	8,167,244	39.59%	76.84%
Total Little Shots Nevada L.L.C.	<u>18,113,423</u>	<u>87.81%</u>	
Various Holders			
Class B	53,821	0.26%	2.73%
Class C	2,461,485	11.93%	23.16%
	<u>20,628,729</u>	<u>100.00%</u>	

Note 10 — Transactions with Related Parties

Services agreement

The Company is a party to a services agreement with the Investors that provides the Company with a license, as well as development and support, for certain of the Company's computer systems and administrative services. The Company pays fees of \$800 per home closing quarterly, in arrears, for these services, which are included in selling,

general and administrative expenses in the consolidated statements of income. During both the three months ended November 30, 2016 and 2015, the Company incurred fees of \$0.5 million and during both the six months ended November 30, 2016 and 2015, the Company incurred fees of \$0.9 million under the services agreement. As of November 30, 2016 and 2015, the balance due to the Investors was \$0.5 million.

Lease agreement

The Company is a party to a lease as a lessee with the Investors to rent approximately 8,000 square feet of commercial space in Dallas, Texas. The initial term of the lease was 66 months, with 49 months remaining as of November 30, 2016. The Company has the option to renew the lease for one additional five-year term. Total minimum lease payments due under the lease were \$0.4 million as of November 30, 2016.

Lot purchase agreements

As of November 30, 2016, the Company is a party to three lot purchase agreements with the Investors. A 10% deposit was required under each of the purchase agreements, and there are no specific performance requirements for the Company. These lot purchase agreements are not required to be recorded as real estate not owned in the consolidated balance sheets. As of November 30, 2016, the total purchase price of lots remaining to be purchased under such agreements was approximately \$22.1 million.

Land development receivables

The Company had \$0.4 million and \$0.8 million in land development receivables due from the Investors at November 30, 2016 and May 31, 2016, respectively, associated with the above-mentioned lot purchase agreements. The amounts are included in receivables in the condensed consolidated balance sheets (see Note 1(e)).

Joint venture

The Company is a party to a land joint venture with the Investors, which is accounted for under the equity method. The Company has an equity investment of less than 50% in the joint venture and does not have a controlling interest in the unconsolidated entity. Also, the Company is a party to a lot purchase agreement with the joint venture to purchase 109 lots. A 10% deposit was required under the purchase agreement and there are no specific performance requirements for the Company. As of November 30, 2016, the total purchase price of lots remaining to be purchased was \$11.5 million. As of November 30, 2016, the joint venture had debt outstanding of \$6.4 million, which is non-recourse to the joint venture and to the Company. The loan was obtained to acquire the land and fund the first phase of land development. The Company provided the lender with a performance guarantee for the substantial completion of the first phase of development for this joint venture. The guarantee of performance may include the payment of money for costs incurred during the completion of the development. In the event that the Company pays money or performs any services pursuant to the guarantee, the joint venture has agreed to indemnify and reimburse the Company for any such costs incurred.

Offsite road improvements agreement

During the year ended May 31, 2016, the Company entered into a joint development agreement with the Investors and an affiliate of the Company's largest minority equity holder for the construction of offsite road improvements adjacent to a land parcel. The Company will be paid a fee for the oversight of the improvements. Work has not commenced, and no payments were made to the Company during the three and six months ended November 30, 2016, pursuant to the development agreement.

Note 11 — Long-Term Incentive Plan

In July 2012, the Board of Directors adopted the Ashton Woods USA L.L.C. 2013 Performance Share Plan (the "2013 Plan"), a long-term incentive compensation program designed to align the interests of the Company and its executives by enabling key employees to participate in the Company's future growth. In July 2013, the Board of Directors adopted the Amended and Restated Performance Share Plan (the "First Amended Plan"), and in July 2016, the Board of Directors adopted the Second Amended and Restated Performance Share Plan, with an effective date of June 1, 2016 (the "Second Amended Plan") (together with the 2013 Plan and the First Amended Plan, the "Plan"). The Plan provides for the grant to participants of full-value performance shares and appreciation-only performance shares, which are the equivalent of phantom equity awards. Full-value performance shares allow the participant to receive a cash payment equal to the total value of the performance share on the designated date of payment. Appreciation-only

performance shares allow the participant to receive a cash payment equal to the increase in value of the performance share measured from the date of grant to the designated date of payment. The Board of Directors approved awards to the Company's Chief Executive Officer, Chief Financial Officer and Chief Legal Officer in July 2012, and in July of 2013, 2014, 2015, and 2016 awarded additional performance shares to these officers, along with certain members of the corporate and operating division senior management teams.

The value of a performance share awarded under the 2013 Plan and the First Amended Plan is determined by multiplying the Company's book value, as defined under the Plan, by a multiple that is equal to the weighted average multiple of a book value of a share of common stock of a predetermined group of publicly traded homebuilders, divided by the number of performance shares available under the Plan. The value of a performance share under the Second Amended Plan is determined by dividing the Company's book value, as defined under the Plan, by the number of performance shares available under the Plan. Generally, except as determined by the Board upon grant, performance shares awarded under the Plan will vest ratably over three years and will be subject to forfeiture upon the occurrence of certain events, including termination of employment for cause. The performance shares will become fully vested upon a participant's resignation for good reason, the participant's death or disability or a change of control, and with respect to certain grants upon an equity sale, as defined in the Plan. In the absence of a payment event otherwise defined in the Plan, the full-value performance share awards pay out after the third anniversary of the award date, and the appreciation-only performance share awards pay out after the fifth anniversary of the award date.

The following table represents a rollforward of the outstanding performance shares as of November 30, 2016:

	Full-value shares	Appreciation- only shares	Total shares
Outstanding performance shares as of May 31, 2016	117,303	314,688	431,991
Performance shares awarded during the period	79,636	159,272	238,908
Fully vested performance shares paid	(32,804)	(41,196)	(74,000)
Total outstanding performance shares as of November 30, 2016	<u>164,135</u>	<u>432,764</u>	<u>596,899</u>
Total vested performance shares as of November 30, 2016	<u>54,455</u>	<u>213,400</u>	<u>267,855</u>

The Company has elected to account for performance shares awarded under the Plan using the intrinsic value method. The Company's liability for performance shares awarded under the Plan is remeasured quarterly to reflect the intrinsic value of the performance shares awarded as of the balance sheet date. As a result, the Company may record an increase or decrease in compensation expense in any period. Compensation expense for the full-value and appreciation-only performance shares is included in selling, general and administrative expenses in the condensed consolidated statements of income.

The total number of performance shares vested as of November 30, 2016 and May 31, 2016 was 267,855 and 300,938, respectively. For each of the three months ended November 30, 2016 and 2015, the Company recorded \$0.4 million, and for the six months ended November 30, 2016 and 2015, the Company recorded \$0.6 million and \$0.7 million, respectively, in compensation expense associated with the full-value and appreciation-only performance shares. For the six months ended November 30, 2016 and 2015, \$1.3 million (74,000 units) and \$0.9 million (56,270 units), respectively, of vested performance shares were paid out to employees. As of November 30, 2016 and May 31, 2016, the Company's liability for the performance shares was \$2.5 million and \$3.1 million, respectively, which is recorded in other liabilities in the condensed consolidated balance sheets.

Note 12 — Fair Value Disclosures

ASC Subtopic 820, *Fair Value Measurement*, defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This standard establishes a three-level hierarchy for fair value measurements based upon the significant inputs used to determine fair value. Observable inputs are those that are obtained from market participants external to the Company while unobservable inputs are generally developed internally, utilizing management's estimates, assumptions and specific knowledge of the assets/liabilities and related markets. The three levels are defined as follows:

- **Level 1:** Valuation is based on quoted prices in active markets for identical assets and liabilities.

- **Level 2:** Valuation is determined from quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar instruments in markets that are not active, or by model-based techniques in which all significant inputs are observable in the market.
- **Level 3:** Valuation is derived from model-based techniques in which at least one significant input is unobservable and based on the Company's own estimates about the assumptions that market participants would use to value the asset or liability.

The carrying amounts of cash and cash equivalents, restricted cash, accounts receivable, accounts payable, customer deposits, notes payable, and the Restated Revolver, as reported in the accompanying consolidated balance sheets, approximate their fair values due to their short-term maturity or floating interest rate terms, as applicable. The factors considered in determining fair values of the Company's communities when necessary under ASC 360 are described in the discussion of the Company's inventory impairment analysis (see Note 1), and are classified as Level 3 valuations.

The following table presents the carrying amounts and estimated fair values of the Company's 6.875% Notes at November 30, 2016 and May 31, 2016:

Fair Value Hierarchy	November 30, 2016		May 31, 2016		
	Carrying Amount	Fair Value	Carrying Amount	Fair Value	
(in thousands)					
Liabilities:					
6.875% Notes	Level 2	\$ 343,774	\$ 336,000	\$ 342,971	\$ 304,500

The Company's 6.875% Notes are recorded at their carrying values in the condensed consolidated balance sheets, which may differ from their respective fair values. The carrying values of the Company's 6.875% Notes reflect their face amount, adjusted for any unamortized debt issuance costs and discount. The fair value of the 6.875% Notes is derived from quoted market prices by independent dealers (Level 2).

Note 13 — Commitments and Contingencies

The Company is involved in lawsuits and other contingencies in the ordinary course of business. Management believes that, while the ultimate outcome of these ordinary course matters cannot be predicted with certainty, the ultimate liability, if any, net of anticipated recoveries including from insurance, will not have a material adverse effect on the Company's financial condition, results of operations, or cash flows.

In addition, as reported in the Company's annual report for fiscal year 2016, on June 27, 2016, FCC Marsh, LLC (the "Seller") filed a complaint against the Company in the Circuit Court for Collier County, Florida, alleging that the Company breached a lot purchase agreement that provided the Seller with a specific performance right against the Company, subject to certain conditions, by allegedly failing to close on certain lot purchases. The Seller has dismissed its claim for specific performance, and seeks declaratory relief and damages. The Company has filed a counterclaim seeking declaratory relief, return of the earnest money deposit and foreclosure of the mortgage that secures that deposit. In December 2016, the court ordered the parties to mediate the dispute within sixty (60) days following the court's order. While it is premature to predict the ultimate outcome of these proceedings, the Company intends to vigorously defend the lawsuit and pursue its claims against the Seller.

The Company has entered into employment agreements with its executive officers and certain other officers that provide for severance payments based on salary and the most recent bonus paid or target bonus upon termination without cause, or, with respect to certain of these officers, following a change of control, by the Company without cause or by the executive for good reason.

In the normal course of business, the Company provides letters of credit and surety bonds to third parties to secure performance and provide deposits under various contracts and commitments. At November 30, 2016 and May 31, 2016, the Company had letters of credit outstanding of \$6.2 million and \$7.4 million, respectively, and surety bonds outstanding of \$18.2 million and \$16.3 million, respectively. As of November 30, 2016, the Company had \$38.8 million of unused letters of credit capacity under the Restated Revolver.

The Company enters into various option purchase agreements to acquire land. In connection with such agreements, the Company has made nonrefundable deposits of \$60.9 million as of November 30, 2016. The Company would forfeit the remaining deposits if the lots are not purchased. The total purchase price of lots remaining to be purchased under option agreements with nonrefundable deposits was approximately \$443.3 million as of November 30, 2016.

Note 14 — Information on Segments

The Company's homebuilding reportable segments are as follows:

- 1) **East:** Raleigh, Charleston, Atlanta, Orlando, and Southwest Florida (Tampa, Sarasota and Naples)
- 2) **Central:** Houston, Dallas, Austin, San Antonio, and Phoenix

The following table summarizes revenue, gross profit, depreciation and amortization, equity in earnings in unconsolidated entities, and net income for each of the Company's reportable segments (in thousands):

	Three months ended November 30,		Six months ended November 30,	
	2016	2015	2016	2015
Revenues:				
Homebuilding:				
East	\$ 159,984	\$ 142,684	\$ 280,280	\$ 249,347
Central	117,010	102,033	210,366	200,114
Consolidated revenues	\$ 276,994	\$ 244,717	\$ 490,646	\$ 449,461
Gross profit:				
Homebuilding:				
East	\$ 31,281	\$ 26,154	\$ 50,907	\$ 47,201
Central	21,410	17,778	38,193	35,191
Consolidated gross profit	\$ 52,691	\$ 43,932	\$ 89,100	\$ 82,392
Depreciation and amortization:				
East	\$ 2,123	\$ 1,954	\$ 3,924	\$ 3,614
Central	1,494	1,324	2,974	2,670
Consolidated depreciation and amortization	\$ 3,617	\$ 3,278	\$ 6,898	\$ 6,284
Equity in earnings in unconsolidated entities:				
East	\$ —	\$ —	\$ —	\$ —
Central	146	346	263	647
Consolidated equity in earnings in unconsolidated entities	\$ 146	\$ 346	\$ 263	\$ 647
Net income:				
East	\$ 8,890	\$ 5,569	\$ 8,293	\$ 7,904
Central	3,891	1,838	4,465	3,162
	12,781	7,407	12,758	11,066
Other ⁽¹⁾	(3,119)	(2,794)	(6,248)	(5,836)
Consolidated net income	\$ 9,662	\$ 4,613	\$ 6,510	\$ 5,230

(1) "Other" primarily consists of interest directly expensed.

The following table summarizes total assets for each of the Company's reportable segments (in thousands):

	November 30, 2016	May 31, 2016
Assets:		
Homebuilding:		
East	\$ 582,186	\$ 540,396
Central	401,866	339,256
	<u>984,052</u>	<u>879,652</u>
Other ⁽²⁾	6,702	6,411
Consolidated assets	<u>\$ 990,754</u>	<u>\$ 886,063</u>

(2) "Other" is comprised of restricted cash and corporate assets.

The following table summarizes additions to property and equipment for each of the Company's reportable segments for the periods presented (in thousands):

	Three months ended November 30,		Six months ended November 30,	
	2016	2015	2016	2015
Additions to property and equipment:				
Homebuilding:				
East	\$ 783	\$ 1,706	\$ 2,203	\$ 3,285
Central	1,325	1,989	2,574	3,624
	<u>2,108</u>	<u>3,695</u>	<u>4,777</u>	<u>6,909</u>
Other ⁽³⁾	1	153	1	171
Consolidated additions to property and equipment	<u>\$ 2,109</u>	<u>\$ 3,848</u>	<u>\$ 4,778</u>	<u>\$ 7,080</u>

(3) "Other" is comprised of property and equipment additions for the Company's Corporate office.

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

The following management's discussion and analysis is intended to assist the reader in understanding the Company's business and is provided as a supplement to, and should be read in conjunction with, the Company's consolidated financial statements and accompanying notes. The Company's results of operations discussed below are presented in conformity with U.S. GAAP.

Forward-Looking Statements

Certain statements included in this report contain forward-looking statements as defined by the Private Securities Litigation Reform Act of 1995, which represent our expectations or beliefs concerning future events, and no assurance can be given that the results described in this report will be achieved. These forward-looking statements can generally be identified by the use of statements that include words such as "estimate," "project," "believe," "expect," "anticipate," "intend," "plan," "foresee," "likely," "will," "target," "could," "seek", or other similar words or phrases. All forward-looking statements are based upon information available to us as of the date of this report.

A forward-looking statement speaks only as of the date on which such statement is made, and, except as required by law, we undertake no obligation to update or revise any forward-looking statement, to reflect events or circumstances after the date on which such statement is made, or to reflect the occurrence of unanticipated events or new information, even if future events make it clear that any expected results that we have expressed or implied will not be realized. Though we are of the view that such forward-looking statements are reasonable, the results or savings or benefits in the forward-looking statement may not be achieved. New factors emerge from time to time and it is not possible for management to predict all such factors.

These forward-looking statements reflect our best estimates and are subject to risks, uncertainties, and other factors, many of which are outside of our control, which could cause actual results to differ materially from the results discussed in the forward-looking statements. These factors include, but are not limited to, the following:

- Fluctuations in mortgage interest rates and the availability of mortgage financing;
- The availability of high quality undeveloped land and improved lots at suitable prices;
- The volatility of the capital markets and the banking industry;
- An ownership change which could have unfavorable implications for our debt instruments;
- The availability of qualified employees, skilled labor, qualified subcontractors, and raw materials;
- The competitive nature of the homebuilding industry;
- Deterioration of the economic climate either nationally or in the regions in which we operate, which could impact growth and expansion opportunities, impact the price of labor and materials, impact the value of our inventory and impact inflation, consumer confidence and consumer preferences;
- Government regulatory actions, which could affect tax laws and could result in fines, penalties, delays, or increased costs in obtaining necessary permits and complying with environmental safety and other laws and regulations;
- Timing of permits and other regulatory approvals;
- Our substantial indebtedness and our ability to comply with the related financial and other covenants and our ability to obtain replacement financing as these instruments mature;
- The cost and availability of insurance and the level of warranty claims;
- Judgments or other costs and exposure with respect to litigation and claims;
- Changes in accounting guidelines or our interpretation of those guidelines;
- Adverse weather conditions and acts of war or terror; and
- Other factors over which the Company has little or no control.

Overview

The housing industry continues to experience healthy inventory supply and demand levels in most markets, supported by a steady U.S. economy and generally improving conditions in the overall economy. The continuing demand for new homes has resulted in rising average sales prices, as well as rising land and labor costs, and in some markets labor shortages. The cost increases are out-pacing home price increases in many markets, creating pressure on both margins and cycle times.

We design, build, and market attached and detached single-family homes for entry-level, move-up, and multi-move-up buyers in six states. Of the 1,110 homes closed for the six months ended November 30, 2016, 960 (86%) were from communities we consider to be move-up or multi-move-up, with 150 (14%) from communities we consider to be entry-level. Furthermore, 899 (81%) of the homes closed were single-family detached product, while the remaining 211 (19%) of the homes closed were single-family attached product.

Of our 123 active communities as of November 30, 2016, we consider 111 (90%) to be move-up or multi-move-up communities, with 12 (10%) considered to be entry-level communities.

Results of operations

The consolidated financial statements included herein have been prepared in accordance with GAAP and in accordance with Article 10 of Regulation S-X.

	Three months ended November 30,		Six months ended November 30,	
	2016	2015	2016	2015
Revenues:	(in thousands)			
Home sales	\$ 276,994	\$ 244,717	\$ 490,646	\$ 449,461
Land sales	430	455	560	455
	<u>\$ 277,424</u>	<u>\$ 245,172</u>	<u>\$ 491,206</u>	<u>\$ 449,916</u>
Gross profit:				
Home sales	\$ 52,691	\$ 43,932	\$ 89,100	\$ 82,392
Land sales	(29)	—	(27)	—
	<u>\$ 52,662</u>	<u>\$ 43,932</u>	<u>\$ 89,073</u>	<u>\$ 82,392</u>
Selling, general and administrative	\$ 37,656	\$ 34,282	\$ 71,941	\$ 66,982
Net income ⁽¹⁾	\$ 9,662	\$ 4,613	\$ 6,510	\$ 5,230

(1) Because we are structured as a limited liability company, income tax obligations are paid by our Members and are not borne by us. Therefore, our net income is higher than it would be if we were structured as a corporation. However, as a limited liability company, we periodically make distributions to our Members. The Company made distributions of \$12.3 million and \$6.3 million during the six months ended November 30, 2016 and 2015, respectively.

	Three months ended November 30,		Six months ended November 30,	
	2016	2015	2016	2015
	(\$ in thousands)			
Supplemental data:				
Active communities at end of period	123	107	123	107
Net new home orders (in units)	594	580	1,289	1,222
Homes closed (in units) ⁽²⁾	625	596	1,110	1,071
Average sales price per home closed	\$ 443	\$ 411	\$ 442	\$ 420
Backlog at end of period (in units)	1,358	1,364	1,358	1,364
Sales value of backlog at end of period	\$ 608,113	\$ 613,568	\$ 608,113	\$ 613,568
Home gross margin ⁽³⁾	19.0%	18.0%	18.2%	18.3%
Adjusted home gross margin ⁽⁴⁾	20.8%	19.7%	20.0%	20.3%
Ratio of selling, general and administrative expenses to home sales revenue	13.6%	14.0%	14.7%	14.9%
Interest incurred ⁽⁵⁾	\$ 8,753	\$ 7,971	\$ 17,127	\$ 15,370
EBITDA ⁽⁶⁾	\$ 21,441	\$ 15,125	\$ 28,665	\$ 26,227
EBITDA margin ⁽⁶⁾	7.7%	6.2%	5.8%	5.8%
Total debt to total capitalization	64.3%	64.5%	64.3%	64.5%
Total net debt to net capitalization	64.3%	64.5%	64.3%	64.5%
Cancellation rate (as a percentage of gross sales)	12.4%	13.4%	12.7%	13.1%

- (2) A home is included in “homes closed” when title to and possession of the property is transferred to the buyer. Revenues and cost of sales for a home are recognized at the time of the closing of a sale, when title to and possession of the property are transferred to the buyer.
- (3) Home gross margin is defined as the difference between home sales revenues and cost of sales—homes, expressed as a percentage of home sales revenues. Cost of sales—homes includes the land costs, home construction costs, indirect costs of construction, previously capitalized interest, a reserve for warranty expense, architecture fee amortization, impairment charges, closing costs, and pre-acquisition costs related to real estate purchases that are no longer probable.
- (4) Adjusted home gross margin is not a financial measure under GAAP and should not be considered an alternative to home gross margin determined in accordance with GAAP as an indicator of operating performance. We use this measure to evaluate our performance against other companies in the homebuilding industry and believe it is also relevant and useful to investors. Adjusted home gross margin is home gross margin that is adjusted for inventory impairments and interest amortized to cost of sales. The following is a reconciliation of home gross margin, which is the most directly comparable GAAP measure, to adjusted home gross margin:

	Three months ended November 30,		Six months ended November 30,	
	2016	2015	2016	2015
	(in thousands)			
Home sales revenues	\$ 276,994	\$ 244,717	\$ 490,646	\$ 449,461
Cost of sales - homes	224,303	200,785	401,546	367,069
Home gross margin	52,691	43,932	89,100	82,392
Add: Inventory impairments	68	27	145	60
Interest amortized to cost of sales	4,968	4,372	8,853	8,755
Adjusted home gross margin	\$ 57,727	\$ 48,331	\$ 98,098	\$ 91,207
Ratio of home gross margin to home sales revenue	19.0%	18.0%	18.2%	18.3%
Ratio of adjusted home gross margin to home sales revenue	20.8%	19.7%	20.0%	20.3%

- (5) Interest incurred for any period is the aggregate amount of interest that is capitalized or charged directly to general and administrative expenses during such period. The following table summarizes interest costs incurred, amortized to cost of sales, and expensed during the three and six months ended November 30, 2016 and 2015:

	Three months ended November 30,		Six months ended November 30,	
	2016	2015	2016	2015
	(in thousands)			
Capitalized interest, beginning of period	\$ 11,310	\$ 10,215	\$ 9,951	\$ 10,241
Interest incurred	8,753	7,971	17,127	15,370
Interest amortized to cost of sales	(4,968)	(4,372)	(8,853)	(8,755)
Interest expensed	(3,115)	(2,794)	(6,245)	(5,836)
Capitalized interest, end of period	<u>\$ 11,980</u>	<u>\$ 11,020</u>	<u>\$ 11,980</u>	<u>\$ 11,020</u>

- (6) EBITDA (earnings before interest, taxes, depreciation, and amortization) is a measure commonly used in the homebuilding industry and is presented as a useful adjunct to net income/loss and other measurements under GAAP because it is a meaningful measure of a company's performance, as interest expense, taxes, depreciation, and amortization expense can vary significantly between companies due, in part, to differences in structure, levels of indebtedness, capital purchasing practices, and interest rates. EBITDA is not a financial measure under GAAP and should not be considered an alternative to net income/loss determined in accordance with GAAP as an indicator of operating performance, nor an alternative to cash flows from operating activities determined in accordance with GAAP as a measure of liquidity. Because some analysts and companies may not calculate EBITDA in the same manner as us, the EBITDA information in this report may not be comparable to similar presentations by others. EBITDA margin is calculated by dividing EBITDA by total revenues.

The following is a reconciliation of net income, which is the most directly comparable GAAP measure, to EBITDA:

	Three months ended November 30,		Six months ended November 30,	
	2016	2015	2016	2015
	(in thousands)			
Net income	\$ 9,662	\$ 4,613	\$ 6,510	\$ 5,230
Depreciation and amortization	3,696	3,346	7,057	6,406
Interest amortized to cost of sales	4,968	4,372	8,853	8,755
Interest expensed	3,115	2,794	6,245	5,836
EBITDA	<u>\$ 21,441</u>	<u>\$ 15,125</u>	<u>\$ 28,665</u>	<u>\$ 26,227</u>

Results of operations - Segments

We have grouped our homebuilding operating divisions into two reportable segments, East and Central. At November 30, 2016, our reportable homebuilding segments consisted of homebuilding operating divisions located in the following areas:

- 1) **East:** Raleigh, Charleston, Atlanta, Orlando, and Southwest Florida (Tampa, Sarasota and Naples)
- 2) **Central:** Houston, Dallas, Austin, San Antonio, and Phoenix

Presented below are certain operating and other data for our segments:

Net new home orders (units):

	Three months ended November 30,		Six months ended November 30,	
	2016	2015	2016	2015
East	280	284	669	605
Central	314	296	620	617
Company total	<u>594</u>	<u>580</u>	<u>1,289</u>	<u>1,222</u>

Homes closed (units):

	Three months ended November 30,		Six months ended November 30,	
	2016	2015	2016	2015
East	333	325	590	544
Central	292	271	520	527
Company total	625	596	1,110	1,071

Average sales price per home closed:

	Three months ended November 30,		Six months ended November 30,	
	2016	2015	2016	2015
	(in thousands)			
East	\$ 480	\$ 439	\$ 475	\$ 458
Central	\$ 401	\$ 377	\$ 405	\$ 380
Company average	\$ 443	\$ 411	\$ 442	\$ 420

Backlog (units) at end of period:

	As of November 30,		Change	% Change
	2016	2015		
East	656	692	(36)	(5.2)%
Central	702	672	30	4.5 %
Company total	1,358	1,364	(6)	(0.4)%

Sales value of backlog at end of period:

	As of November 30,		Change	% Change
	2016	2015		
	(in thousands)			
East	\$ 306,369	\$ 340,009	\$ (33,640)	(9.9)%
Central	301,744	273,559	28,185	10.3 %
Company total	\$ 608,113	\$ 613,568	\$ (5,455)	(0.9)%

Active communities:

	As of November 30,		Change	% Change
	2016	2015		
East	56	53	3	5.7%
Central	67	54	13	24.1%
Company total	123	107	16	15.0%

The Company presents adjusted home gross margin in this discussion. Adjusted home gross margin is a non-GAAP measure. The following is a reconciliation of home gross margin, the most directly comparable U.S. GAAP measure, to adjusted home gross margin:

	Three months ended November 30,		Six months ended November 30,	
	2016	2015	2016	2015
Homebuilding East:	(in thousands)			
Home sales revenues	\$ 159,984	\$ 142,684	\$ 280,280	\$ 249,347
Cost of sales - homes	128,703	116,530	229,373	202,146
Home gross margin	31,281	26,154	50,907	47,201
Add: Inventory impairments	54	—	131	—
Interest amortized to cost of sales	3,003	2,508	5,177	4,398
Adjusted home gross margin	<u>\$ 34,338</u>	<u>\$ 28,662</u>	<u>\$ 56,215</u>	<u>\$ 51,599</u>
Ratio of home gross margin to home sales revenues	19.6%	18.3%	18.2%	18.9%
Ratio of adjusted home gross margin to home sales revenues	21.5%	20.1%	20.1%	20.7%
Homebuilding Central:				
Home sales revenues	\$ 117,010	\$ 102,033	\$ 210,366	\$ 200,114
Cost of sales - homes	95,600	84,255	172,173	164,923
Home gross margin	21,410	17,778	38,193	35,191
Add: Inventory Impairments	14	27	14	60
Interest amortized to cost of sales	1,965	1,864	3,676	4,357
Adjusted home gross margin	<u>\$ 23,389</u>	<u>\$ 19,669</u>	<u>\$ 41,883</u>	<u>\$ 39,608</u>
Ratio of home gross margin to home sales revenues	18.3%	17.4%	18.2%	17.6%
Ratio of adjusted home gross margin to home sales revenues	20.0%	19.3%	19.9%	19.8%

Results of operations - Discussion

Three and Six Months Ended November 30, 2016 Compared to Three and Six Months Ended November 30, 2015

Home sales revenues - Consolidated

Home sales revenues increased by 13.2% (\$32.3 million) and 9.2% (\$41.2 million) for the three and six months ended November 30, 2016 to \$277.0 million and \$490.6 million, respectively, from \$244.7 million and \$449.5 million for the three and six months ended November 30, 2015, respectively. The increase in revenues was due to increases in both the average sales price of homes closed and in the number of homes closed on a consolidated basis. The average sales price of homes closed increased 7.8% and 5.2% in the three and six months ended November 30, 2016 to \$443,000 and \$442,000, respectively, compared to \$411,000 and \$420,000 for the three and six months ended November 30, 2015, respectively. The number of homes closed increased 4.9% and 3.6% in the three and six months ended November 30, 2016 to 625 and 1,110, respectively, compared to 596 and 1,071 for the three and six months ended November 30, 2015, respectively.

The increase in the average sales price of homes closed on a consolidated basis for the three months ended November 30, 2016 compared to the three months ended November 30, 2015 was attributable to an increase in the average sales price of homes closed of 6.4% in the central segment and 9.3% in the east segment. The 4.9% increase in the number of homes closed during the three months ended November 30, 2016 was attributable to an increase of 2.5% in the number of homes closed during the three months ended November 30, 2016 in the east segment and an increase of 7.7% in the number of homes closed during the three months ended November 30, 2016 in the central segment.

The increases in the average sales price of homes closed on a consolidated basis for the six months ended November 30, 2016 compared to the six months ended November 30, 2015 was attributable to an increase of 6.6% in the central segment and 3.7% in the east segment. The 3.6% increase in the number of homes closed during the six months ended November 30, 2016 was attributable to an increase of 8.5% in the number of homes closed during the six months ended November 30, 2016 in the east segment offset by a decrease of 1.3% in the number of homes closed during the six months ended November 30, 2016 in the central segment.

Home sales revenues - East segment

Home sales revenues for the east segment increased by 12.1% (\$17.3 million) and 12.4% (\$30.9 million) for the three and six months ended November 30, 2016 to \$160.0 million and \$280.3 million, respectively, from \$142.7 million and \$249.3 million, respectively, for the three and six months ended November 30, 2015. The increase in revenues for the three and six months ended November 30, 2016 was due to an increase in the number of homes closed, as well as an increase in the average sales price of homes closed. The number of homes closed during the three and six months ended November 30, 2016 increased 2.5% (8 homes) and 8.5% (46 homes), respectively, as compared to the three and six months ended November 30, 2015. The average sales price of homes closed increased 9.3% and 3.7% in the three and six months ended November 30, 2016, respectively, to an average of \$480,000 and \$475,000, respectively, from an average of \$439,000 and \$458,000 for the three and six months ended November 30, 2015, respectively.

The increase in the average sales price of homes closed for the three and six months ended November 30, 2016 was primarily due to increased pricing in certain of our markets as a result of favorable market conditions, which allowed us to increase sales prices and/or reduce incentives in certain communities throughout the east segment. In addition, the mix of communities from which we had closings impacted the average sales price as we had a higher number of closings in communities with higher price points.

Home sales revenues - Central segment

Home sales revenues for the central segment increased by 14.7% (\$15.0 million) and 5.1% (\$10.3 million) for the three and six months ended November 30, 2016 to \$117.0 million and \$210.4 million, respectively, from \$102.0 million and \$200.1 million for the three and six months ended November 30, 2015, respectively. The increase in revenues for the three and six months ended November 30, 2016 was due to an increase in the average sales price of homes closed for the three and six months ended November 30, 2016, and for the three months ended November 30, 2016 an increase in the number of homes closed. During the six months ended November 30, 2016 the increase driven by the increase in the average sales price was offset in part by a decrease in the number of homes closed. The average sales price of homes closed increased 6.4% and 6.6% in the three and six months ended November 30, 2016 to an average of \$401,000 and \$405,000, respectively, from an average of \$377,000 and \$380,000 for the three and six months ended November 30, 2015, respectively. The number of homes closed during the three months ended November 30, 2016 increased 7.7% (21 homes) compared to the three months ended November 30, 2015. The number of homes closed during the six months ended November 30, 2016 decreased 1.3% (7 homes) compared to the six months ended November 30, 2015.

The increase in the average sales price of homes closed during the three months ended November 30, 2016 was primarily due to product mix (selling at different price points and in different geographic locations) and increased pricing in certain of our markets due to favorable market conditions. Of the 292 homes closed in the three months ended November 30, 2016, 270 (92%) were from communities that we consider move-up or multi-move-up, which generally have higher price points. This compares to 88% (238 of 271 homes closed) in the three months ended November 30, 2015.

The increase in the average sales price of homes closed during the six months ended November 30, 2016 was primarily due to product mix (selling at different price points and in different geographic locations) and increased pricing in certain of our markets due to favorable market conditions. Of the 520 homes closed in the six months ended November 30, 2016, 485 (93%) were from communities that we consider move-up or multi-move-up, which generally have higher price points. This compares to 88% (465 of 527 homes closed) in the six months ended November 30, 2015.

Net new home orders and backlog - Consolidated

Net new home orders and backlog do not have a current effect on our revenues; however, both provide important information about our future revenues and business prospects. New home orders are converted to revenues at the time of the home closing, which is generally within nine months of the date the home is sold. Net new home orders increased

2.4% (14 homes) and 5.5% (67 homes) for the three and six months ended November 30, 2016, respectively, compared to the three and six months ended November 30, 2015. Backlog decreased 0.4% from 1,364 homes in backlog at November 30, 2015 to 1,358 homes in backlog at November 30, 2016. The decrease in backlog is a result of the Company closing 2,722 homes, which is 6 more homes than were sold (2,716 homes sold) during the twelve months ended November 30, 2016. The sales value of backlog at November 30, 2016 was \$608.1 million, a 0.9% decrease from the sales value of backlog at November 30, 2015 of \$613.6 million. The average sales price of homes in backlog decreased 0.4% from \$450,000 at November 30, 2015 to \$448,000 at November 30, 2016. The decrease in the consolidated average sales price of homes in backlog is a result of a decrease in the average sales price of homes in backlog in the east segment offset by an increase in the average sales price of homes in backlog in the central segment.

Net new home orders and backlog - East segment

Net new home orders in the east segment decreased 1.4% (4 homes) during the three months ended November 30, 2016, compared to the three months ended November 30, 2015. Net new home orders in the east segment increased 10.6% (64 homes) during the six months ended November 30, 2016, compared to the six months ended November 30, 2015. Backlog consisted of 656 homes at November 30, 2016, which is a 5.2% decrease from 692 homes in backlog at November 30, 2015. The sales value of backlog at November 30, 2016 was \$306.4 million, a 9.9% decrease over the sales value of backlog at November 30, 2015 of \$340.0 million. The decrease in backlog is a result of closing 20 more homes than we sold during the twelve months ended November 30, 2016. The east segment closed 1,368 homes, while selling 1,348 homes during the twelve months ended November 30, 2016. The decrease in the average sales value of backlog was primarily driven by a slightly higher percentage of entry-level homes in backlog. At November 30, 2016, 131 (20%) of the 656 homes in backlog were what we consider to be entry-level homes compared to 123 (18%) of the 692 homes in backlog at November 30, 2015.

Net new home orders and backlog - Central segment

Net new home orders increased 6.1% (18 homes) and 0.5% (3 homes) during the three and six months ended November 30, 2016, respectively, compared to the three and six months ended November 30, 2015. Backlog consisted of 702 homes at November 30, 2016, which is a 4.5% increase from the 672 homes in backlog at November 30, 2015. The sales value of backlog at November 30, 2016 was \$301.7 million, a 10.3% increase over sales value of backlog at November 30, 2015 of \$273.6 million. The average sales price of homes in backlog increased 5.7% from \$407,000 at November 30, 2015, to \$430,000 at November 30, 2016. The increase in backlog is the result of selling 30 more homes than we closed during the twelve months ended November 30, 2016. The central segment sold 1,348 homes, while closing 1,318 homes during the twelve months ended November 30, 2016. The increase in the average sales value of backlog was primarily driven by a higher percentage of move-up and multi-move-up homes in backlog. At November 30, 2016, 627 (89%) of the 702 homes in backlog were what we consider to be move-up or multi-move-up homes compared to 554 (82%) of the 672 homes in backlog at November 30, 2015.

Gross margins - Consolidated

The average gross margin from homes closed for the three months ended November 30, 2016 increased to 19.0% from 18.0% for the three months ended November 30, 2015. The average gross margin from homes closed for the six months ended November 30, 2016 decreased to 18.2% from 18.3% for the six months ended November 30, 2015. Adjusted gross margin from homes closed for the three months ended November 30, 2016 increased to 20.8% from 19.7% for the three months ended November 30, 2015. Adjusted gross margin from homes closed for the six months ended November 30, 2016 decreased to 20.0% from 20.3% for the six months ended November 30, 2015.

The increases for the three months ended November 30, 2016 in both the average gross margin and adjusted gross margin on a consolidated basis reflect a number of factors, including an increase in the average sales price of homes closed, partially offset by higher land costs as a percentage of revenue. Construction costs as a percentage of revenue did not increase enough to offset the increase in average sales price.

The average gross margin and adjusted gross margin on a consolidated basis for the six months ended November 30, 2016 remained relatively flat compared to the six months ended November 30, 2015. Increases in land costs, as a percentage of revenue, were mostly offset by reductions in construction costs, as a percentage of revenue. The decrease in construction costs as a percentage of revenue, is a result of a number of factors, including shifts in community mix (selling at higher price points and in different geographical locations) and an increase in the average sales price of homes closed. While the average gross margin and adjusted gross margin remained relatively flat for the six months ended November 30, 2016 compared to the six months ended November 30, 2015 on a consolidated basis, this is a

result of a decrease in the average gross margin in the east segment, largely offset by an increase in the average gross margin in the central segment.

Gross margins - East segment

The average gross margin from homes closed for the three months ended November 30, 2016 increased to 19.6%, compared to 18.3% for the three months ended November 30, 2015. The average gross margin from homes closed for the six months ended November 30, 2016 decreased to 18.2%, compared to 18.9% for the six months ended November 30, 2015.

The increase in average gross margin for the three months ended November 30, 2016 reflects a combination of factors, including a reduction in construction costs as a percentage of revenue due to shifts in community mix (selling at higher price points and in different geographic locations) and an increase in the average sales price of homes closed, offset in part by higher land costs as a percentage of revenue.

The decrease in average gross margin for the six months ended November 30, 2016 is primarily due to an increase in certain costs of operating communities, as a percentage of revenue, due to a decrease in the inventory turns for the east segment, as well as higher land costs as a percentage of revenue.

Gross margins - Central segment

The average gross margin from homes closed for the three and six months ended November 30, 2016 increased to 18.3% and 18.2%, respectively, from 17.4% and 17.6% in the six months ended November 30, 2015, respectively.

The increase in average gross margins for the three months ended November 30, 2016 reflects a combination of factors, including a reduction in construction costs as a percentage of revenue, shifts in community mix (selling at higher price points and different geographic locations), and an increase in the average sales price of homes closed, offset in part by higher land costs as a percentage of revenue.

The increase in average gross margin for the six months ended November 30, 2016 reflects a combination of factors, including a reduction in construction costs as a percentage of revenue due to shifts in community mix (selling at higher price points and different geographic locations) and an increase in the average sales price of homes closed, as well as a decrease in the interest amortized to cost of sales, as a percentage of revenue, offset in part by higher land costs as a percentage of revenue.

Selling, general and administrative expenses

SG&A totaled \$37.7 million and \$71.9 million for the three and six months ended November 30, 2016, respectively, compared to \$34.3 million and \$67.0 million for the three and six months ended November 30, 2015, respectively. While SG&A increased by \$3.4 million and \$5.0 million for the three and six months ended November 30, 2016, respectively, as compared to the three and six months ended November 30, 2015, SG&A as a percentage of revenue decreased to 13.6% and 14.7% for the three and six months ended November 30, 2016, respectively, from 14.0% and 14.9% for the three and six months ended November 30, 2015, respectively.

The increase in SG&A for the three months ended November 30, 2016 is primarily related to an increase in sales commissions due to increases in the number of closings and in average sales prices, as discussed above, as well as increases in other compensation expense.

The increase in SG&A for the six months ended November 30, 2016 is primarily related to an increase in sales commissions due to increases in the number of closings and in average sales prices, as discussed above, as well as increases in maintenance costs for our finished model and spec homes, and in other compensation expense.

Land sales

We periodically elect to sell parcels of land or lots. These land and lot sales are incidental to our business of selling and building homes. We had \$0.4 million and \$0.6 million in sales of land and lots during the three and six months ended November 30, 2016, respectively, and \$0.5 million in sales of land and lots during both the six months ended November 30, 2015. No significant profits or losses were realized from the sales of land and lots, as the parcels were generally sold at prices that were substantially equivalent to their cost basis.

Net income

Net income increased \$5.1 million to \$9.7 million for the three months ended November 30, 2016 compared to net income of \$4.6 million for the three months ended November 30, 2015. The increase in net income for the three months ended November 30, 2016 as compared to the three months ended November 30, 2015 is primarily attributable to an increase in home sales revenue, in addition to a slight decrease in SG&A expense as a percentage of revenue, as discussed above.

Net income increased \$1.3 million to \$6.5 million for the six months ended November 30, 2016 compared to net income of \$5.2 million for the six months ended November 30, 2015. The increase in net income for the six months ended November 30, 2016 as compared to the six months ended November 30, 2015 is primarily attributable to an increase in home sales revenue, in addition to a slight decrease in SG&A expense as a percentage of revenue, as discussed above.

Liquidity and capital resources

Our principal uses of cash are land and lot purchases, land development, home construction, interest costs, and overhead. We currently fund our operations with cash flows from operating activities, borrowings under our Fifth Amended and Restated Credit Agreement dated as of July 31, 2015 (the "Restated Revolver"), long-term financing, and equity investments. As we utilize our capital resources and liquidity to fund the growth of our business, we monitor our balance sheet leverage ratios to ensure that we maintain reasonable levels. We also monitor current and expected operational requirements, as well as financial market conditions, to evaluate accessing other available financing sources. Based on our existing financial condition and credit relationships, we believe that our operations and capital resources are sufficient to provide for our current and foreseeable capital needs. However, we continue to evaluate the impact of market conditions on our liquidity and will consider, as appropriate, additional funding opportunities.

Operating cash flows

Net cash used in operating activities for the six months ended November 30, 2016 was \$91.7 million compared to \$84.0 million for the six months ended November 30, 2015. The primary source of operating funds was the sale of homes, and we primarily used these funds to buy and develop land, build homes, pay interest, and fund overhead expenses. The increase in cash used in operating activities was primarily due to an increase in inventory from \$636.4 million at May 31, 2016 to \$750.8 million at November 30, 2016 and a decrease in accounts payable from \$63.7 million at May 31, 2016 to \$61.9 million at November 30, 2016.

Investing cash flows

Net cash used in investing activities was \$5.2 million for the six months ended November 30, 2016 and \$5.7 million for the six months ended November 30, 2015. Net cash used in investing activities for the six months ended November 30, 2016 included \$4.8 million to furnish model homes and sales offices, to build and furnish Design Studios, and to update furnishings in offices and existing communities, as well as \$0.7 million invested in our unconsolidated entities. The cash outflows were partially offset by a \$0.4 million return of investment from our unconsolidated entities.

Financing cash flows

Net cash provided by financing activities was \$96.9 million for the six months ended November 30, 2016, compared to \$89.7 million for the six months ended November 30, 2015. The funds provided by financing activities during the six months ended November 30, 2016 consisted of \$109.4 million of net borrowings under the Restated Revolver, offset by distributions of \$12.3 million to our Members. As of November 30, 2016, we had \$144.2 million of outstanding borrowings under our Restated Revolver and available additional borrowing capacity of \$132.1 million based on outstanding borrowings, outstanding letters of credit, and the value of collateral pledged to secure the facility.

The total debt to total capitalization ratio consists of total debt divided by total capitalization (debt plus members' equity). The net debt to net capitalization ratio consists of total debt, net of cash and restricted cash, divided by net capitalization (debt plus members' equity), net of cash and restricted cash. Our ratios of total debt to total capitalization and net debt to net capitalization each decreased to 64.3% as of November 30, 2016 from 64.5% as of November 30, 2015.

Inventory

As of November 30, 2016, we had the following owned homes in our reportable segments (in units):

	Homes Under Construction			Completed Homes			Total Homes
	Unsold	Models	Sold	Unsold	Models	Sold	
East	230	6	412	48	70	45	811
Central	235	6	494	57	79	36	907
Company total	465	12	906	105	149	81	1,718

As of November 30, 2016 we controlled the following residential homes and lots (in units):

	Total Homes	Finished Lots	Land Under Development	Residential Land Held for Future Development	Total Owned	Total Under Option	Total Controlled
East	811	1,975	351	162	3,299	3,994	7,293
Central	907	830	215	245	2,197	4,365	6,562
Total Company	1,718	2,805	566	407	5,496	8,359	13,855
Percentage of total controlled	12.4%	20.2%	4.1%	2.9%	39.7%	60.3%	100.0%

In addition to the 5,496 lots we owned, we controlled, through the use of purchase and option agreements, 8,359 lots at November 30, 2016. Purchase and option agreements that did not require consolidation under ASC Subtopic 810, *Consolidations*, ASC Subtopic 360-20, *Property, Plant, and Equipment ("ASC 360-20")*, or ASC Subtopic 470-40, *Product Financing Arrangements ("ASC 470-40")* at November 30, 2016 had an aggregate purchase price of \$478.7 million. In connection with these agreements, we had cash deposits of \$62.1 million at November 30, 2016. In addition, we had purchase and option agreements consolidated under ASC 360-20 or ASC 470-40 with an aggregate purchase price of \$115.3 million and cash deposits of \$26.3 million (See Note 4).

The Company owns commercial land in Dallas with a book value of \$1.3 million at both November 30, 2016 and May 31, 2016. The Company is actively marketing the land and meets all the conditions necessary for accounting for such land as held for sale and therefore has classified the commercial land as land held for sale in inventory on the November 30, 2016 unaudited condensed consolidated balance sheet. The land was classified as commercial land on the May 31, 2016 consolidated balance sheet.

During the six months ended November 30, 2016, we acquired 2,379 lots for a total purchase price of \$142.8 million, net of 113 lots (\$12.7 million) of land sold and accounted for under the provisions of ASC 360-20 due to the Company's continuing involvement. We spent \$12.9 million on land development for the six months ended November 30, 2016. We spent \$4.8 million during the six months ended November 30, 2016 to furnish model homes and sales offices, to build and furnish Design Studios, and to update furnishings in offices and existing communities.

Aggregate contractual commitments and off-balance sheet arrangements

There have been no significant changes outside the ordinary course of business to our contractual obligations under our debt agreements and lease payments as of November 30, 2016, compared to those contained in our audited consolidated financial statements for the year ended May 31, 2016. Our debt obligations are fully discussed in Note 7 of our unaudited condensed consolidated financial statements as of November 30, 2016.

In the ordinary course of business, we provide letters of credit and surety bonds to third parties to secure performance and provide deposits under various contracts and commitments. At November 30, 2016, we had letters of credit and surety bonds outstanding of \$6.2 million and \$18.2 million, respectively. As of November 30, 2016, we had \$38.8 million of unused letters of credit capacity under the Restated Revolver.

On November 19, 2015, the Company issued a \$2.3 million note payable to an unaffiliated third party which matures on November 19, 2017. The non-interest bearing note is collateralized by the land to which it relates and has no recourse to any other assets or the Company. At November 30, 2016, the outstanding note payable balance totaled \$2.3 million.

On September 23, 2016, the Company issued a \$5.8 million note payable to an unaffiliated third party which has an interest rate of 1.00% and matures on September 23, 2017. The note is collateralized by the land to which it relates and has no recourse to any other assets or the Company. At November 30, 2016, the outstanding note payable balance totaled \$5.8 million.

At November 30, 2016, we controlled 13,855 lots and homes available to close. Of the 13,855 lots and homes controlled, we owned 39.7%, or 5,496 lots and homes, and 60.3%, or 8,359 lots, were under contract. In the ordinary course of business, we enter into purchase and option agreements in order to procure land for the construction of homes in the future. At November 30, 2016, these agreements had an aggregate remaining purchase price of \$478.7 million, net of deposits of \$62.1 million. In addition, we had purchase and option agreements recorded under ASC 360-20 or ASC 470-40 with an aggregate purchase price of \$115.3 million and cash deposits of \$26.3 million. Pursuant to these land purchase and land option agreements, we generally provide a deposit to the seller as consideration for the right, but not the obligation, to purchase land at different times in the future, usually at predetermined prices. In certain instances, we are required to record the land under option as if we own it.

As of November 30, 2016, real estate not owned totaled \$109.9 million related to seven lot purchase agreements. Refer to our discussion in Note 4 of our unaudited condensed consolidated financial statements as of November 30, 2016.

As of November 30, 2016, we participated in three land development joint ventures in which we have less than a controlling interest. We account for our interests in these joint ventures under the equity method. Our share of profits from lots we purchase from these entities is deferred and treated as a reduction of the cost basis of land purchased from the entity. Our share of profits from lots purchased by other parties is recognized immediately and included within equity in earnings in unconsolidated entities in the condensed consolidated statements of income.

Seasonality and inflation

Our historical quarterly results of operations have tended to be variable due to the seasonal nature of the homebuilding industry. We have historically experienced increases in revenues and cash flow from operations during the calendar second quarter based on the timing of home closings. Any period of high inflation is likely to have an adverse effect on us and the homebuilding industry in general since it may contribute to higher land, financing, labor and construction costs. We have, in the past, attempted to pass on at least a portion of the cost increases to our homebuyers via increased sales prices; however, we may be limited in our ability to increase our prices. Further, higher mortgage interest rates may accompany inflation and affect the affordability of mortgage financing for homebuyers. If we are unable to increase our sales prices to compensate for any increased costs, or if mortgage interest rates increase significantly, thereby affecting the ability of potential homebuyers to adequately finance home purchases, our results of operations will likely be adversely affected.

Our operations are also affected by seasonality in cash use. Our cash needs are generally higher from January to April each year as we complete the spring building cycle.

Critical accounting policies and estimates

There have been no significant changes to our critical accounting policies and estimates during the six months ended November 30, 2016, compared with those contained in Note 1 of our audited consolidated financial statements for the fiscal year ended May 31, 2016.

Transactions with related parties

See Note 10 in our unaudited condensed consolidated financial statements as of November 30, 2016 for transactions with related parties. The Company did not have any significant changes in or transactions with related parties during the first six months of fiscal year 2017. See the audited consolidated financial statements for the fiscal year ended May 31, 2016 for transactions existing at such date.

Pending accounting pronouncements

See Note 2 in our unaudited condensed consolidated financial statements as of November 30, 2016.

Item 3. *Quantitative and qualitative disclosures about market risk*

We maintain a mix of variable-rate and fixed-rate debt and our primary market risk exposure for these financial instruments relates to fluctuations in interest rates, which include changes in the U.S. Treasury rates and LIBOR. For our variable-rate debt, our primary exposure is in interest expense.

We do not believe our exposure in these areas is material to cash flows or earnings. The borrowings under the Restated Revolver accrue interest at a variable rate. As of November 30, 2016, we had outstanding borrowings of \$144.2 million under our senior secured revolving credit facility.

Item 4. *Controls and Procedures*

Pursuant to section 4.03 of the 6.875% Notes indenture, the Company is not required to comply with Section 302 or Section 404 of the Sarbanes-Oxley Act of 2002, or related Items 307 and 308 of Regulation S-K promulgated by the Securities and Exchange Commission.

PART II. OTHER INFORMATION

Item 1. *Legal Proceedings*

We are involved in lawsuits and other contingencies in the ordinary course of business. Management believes that, while the ultimate outcome of these ordinary course contingencies cannot be predicted with certainty, the ultimate liability, if any, net of anticipated recoveries including from any insurance, will not have a material adverse effect on our financial condition, results of operations or cash flows.

In addition, as reported in the Company's annual report for fiscal year 2016, on June 27, 2016, FCC Marsh, LLC (the "Seller") filed a complaint against the Company in the Circuit Court for Collier County, Florida, alleging that the Company breached a lot purchase agreement that provided the Seller with a specific performance right against the Company, subject to certain conditions, by allegedly failing to close on certain lot purchases. The Seller has dismissed its claim for specific performance, and seeks declaratory relief and damages. The Company has filed a counterclaim seeking declaratory relief, return of the earnest money deposit and foreclosure of the mortgage that secures that deposit. In December 2016, the court ordered the parties to mediate the dispute within sixty (60) days following the court's order. While it is premature to predict the ultimate outcome of these proceedings, the Company intends to vigorously defend the lawsuit and pursue its claims against the Seller.