Meritage Homes CORP
Form 10-Q
July 30, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)
ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2018
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File Number 1-9977

Meritage Homes Corporation
(Exact Name of Registrant as Specified in its Charter)

Maryland	86-0611231
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)
8800 E. Raintree Drive, Suite 300, Scottsdale, Arizona	85260
(Address of Principal Executive Offices)	(Zip Code)

(480) 515-8100
(Registrant's telephone number, including area code)
N/A
(Former Name, Former Address and Formal Fiscal Year, if Changed Since Last Report)

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

Indicate by a checkmark whether the registrant has submitted electronically every Interactive Date File required to be submitted 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 such files). Yes ý No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	ý	Accelerated filer	¨
Non-accelerated filer	¨	Smaller reporting company	¨
		Emerging growth company	¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange

Act. ¨

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

Common shares outstanding as of July 26, 2018: 40,649,453

MERITAGE HOMES CORPORATION
FORM 10-Q FOR THE QUARTER ENDED JUNE 30, 2018
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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

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

	June 30, 2018	December 31, 2017
Assets		
Cash and cash equivalents	$169,426	$170,746
Other receivables	78,395	79,317
Real estate	2,870,047	2,731,380
Real estate not owned	38,864	38,864
Deposits on real estate under option or contract	48,880	59,945
Investments in unconsolidated entities	16,639	17,068
Property and equipment, net	52,122	33,631
Deferred tax asset	36,294	35,162
Prepaids, other assets and goodwill	84,227	85,145
Total assets	$3,394,894	$3,251,258
Liabilities		
Accounts payable	$154,819	$140,516
Accrued liabilities	173,770	181,076
Home sale deposits	37,130	34,059
Liabilities related to real estate not owned	34,978	34,978
Loans payable and other borrowings	16,552	17,354
Senior notes, net	1,294,705	1,266,450
Total liabilities	1,711,954	1,674,433
Stockholders' Equity		
Preferred stock, par value $0.01. Authorized 10,000,000 shares; none issued and outstanding at June 30, 2018 and December 31, 2017	—	—
Common stock, par value $0.01. Authorized 125,000,000 shares; issued 40,649,453 and 40,330,741 shares at June 30, 2018 and December 31, 2017, respectively	406	403
Additional paid-in capital	593,561	584,578
Retained earnings	1,088,973	991,844
Total stockholders' equity	1,682,940	1,576,825
Total liabilities and stockholders' equity	$3,394,894	$3,251,258

See accompanying notes to unaudited consolidated financial statements

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Homebuilding:				
Home closing revenue	$872,383	$797,780	$1,600,915	$1,458,397
Land closing revenue	5,112	4,198	19,144	16,353
Total closing revenue	877,495	801,978	1,620,059	1,474,750
Cost of home closings	(712,868)	(656,870)	(1,317,070)	(1,210,219)
Cost of land closings	(5,799)	(4,198)	(21,041)	(13,858)
Total cost of closings	(718,667)	(661,068)	(1,338,111)	(1,224,077)
Home closing gross profit	159,515	140,910	283,845	248,178
Land closing gross (loss)/profit	(687)	—	(1,897)	2,495
Total closing gross profit	158,828	140,910	281,948	250,673
Financial Services:				
Revenue	3,870	3,649	6,918	6,593
Expense	(1,693)	(1,551)	(3,177)	(2,930)
Earnings from financial services unconsolidated entities and other, net	3,474	3,459	6,130	6,184
Financial services profit	5,651	5,557	9,871	9,847
Commissions and other sales costs	(60,823)	(54,701)	(113,575)	(103,021)
General and administrative expenses	(34,205)	(29,591)	(65,098)	(59,213)
(Loss)/earnings from other unconsolidated entities, net	(156)	570	(202)	943
Interest expense	(44)	(1,620)	(180)	(2,445)
Other income, net	1,934	2,080	7,305	3,190
Earnings before income taxes	71,185	63,205	120,069	99,974
Provision for income taxes	(17,347)	(21,625)	(22,357)	(34,822)
Net earnings	$53,838	$41,580	$97,712	$65,152
Earnings per common share:				
Basic	$1.32	$1.03	$2.41	$1.62
Diluted	$1.31	$0.98	$2.37	$1.54
Weighted average number of shares:				
Basic	40,647	40,317	40,568	40,248
Diluted	41,164	42,781	41,193	42,836

See accompanying notes to unaudited consolidated financial statements

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

	Six Months Ended June 30, 2018	2017
Cash flows from operating activities:		
Net earnings	$97,712	$65,152
Adjustments to reconcile net earnings to net cash used in operating activities:		
Depreciation and amortization	12,608	7,872
Stock-based compensation	8,976	5,785
Equity in earnings from unconsolidated entities	(5,978)	(7,127)
Distributions of earnings from unconsolidated entities	6,834	6,712
Other	2,407	10
Changes in assets and liabilities:		
Increase in real estate	(155,809)	(211,384)
Decrease in deposits on real estate under option or contract	11,093	9,308
Decrease/(increase) in other receivables, prepaids and other assets	1,634	(9,428)
Increase/(decrease) in accounts payable and accrued liabilities	6,997	(5,497)
Increase in home sale deposits	3,071	7,849
Net cash used in operating activities	(10,455)	(130,748)
Cash flows from investing activities:		
Investments in unconsolidated entities	(417)	(408)
Distributions of capital from unconsolidated entities	—	1,250
Purchases of property and equipment	(15,726)	(8,322)
Proceeds from sales of property and equipment	92	86
Maturities/sales of investments and securities	1,065	1,258
Payments to purchase investments and securities	(1,065)	(1,258)
Net cash used in investing activities	(16,051)	(7,394)
Cash flows from financing activities:		
Repayment of Credit Facility, net	—	(15,000)
Repayment of loans payable and other borrowings	(2,499)	(5,725)
Repayment of senior notes and senior convertible notes	(175,000)	(52,098)
Proceeds from issuance of senior notes	206,000	300,000
Payment of debt issuance costs	(3,315)	(3,998)
Net cash provided by financing activities	25,186	223,179
Net (decrease)/increase in cash and cash equivalents	(1,320)	85,037
Cash and cash equivalents, beginning of period	170,746	131,702
Cash and cash equivalents, end of period	$169,426	$216,739

See Supplemental Disclosure of Cash Flow Information in Note 13.
See accompanying notes to unaudited consolidated financial statements

MERITAGE HOMES CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 — ORGANIZATION AND BASIS OF PRESENTATION

Organization. Meritage Homes is a leading designer and builder of single-family homes. We primarily build in historically high-growth regions of the United States and offer a variety of homes that are designed to appeal to homebuyers primarily focused on first-time and first move-up buyers. We have homebuilding operations in three regions: West, Central and East, which are comprised of nine states: Arizona, California, Colorado, Texas, Florida, Georgia, North Carolina, South Carolina and Tennessee. We also operate a wholly-owned title company, Carefree Title Agency, Inc. ("Carefree Title"). Carefree Title's core business includes title insurance and closing/settlement services we offer to our homebuyers. Through our predecessors, we commenced our homebuilding operations in 1985. Meritage Homes Corporation was incorporated in 1988 in the state of Maryland.

Our homebuilding and marketing activities are conducted under the name of Meritage Homes in each of our homebuilding markets. In limited cases, we also offer luxury homes under the brand name of Monterey Homes in some markets. At June 30, 2018, we were actively selling homes in 253 communities, with base prices ranging from approximately $179,000 to $1,311,000.

Basis of Presentation. The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. These financial statements should be read in conjunction with the consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2017. The consolidated financial statements include the accounts of Meritage Homes Corporation and those of our consolidated subsidiaries, partnerships and other entities in which we have a controlling financial interest, and of variable interest entities (see Note 3) in which we are deemed the primary beneficiary (collectively, “us”, “we”, “our” and “the Company”). Intercompany balances and transactions have been eliminated in consolidation. In the opinion of management, the accompanying unaudited financial statements include all adjustments (consisting only of normal recurring entries), necessary for the fair presentation of our results for the interim periods presented. Results for interim periods are not necessarily indicative of results to be expected for the full year.

Cash and Cash Equivalents. Liquid investments with an initial maturity of three months or less are classified as cash equivalents. Amounts in transit from title companies or closing agents for home closings of approximately $56.4 million and $107.1 million are included in cash and cash equivalents at June 30, 2018 and December 31, 2017, respectively.

Real Estate. Real estate is stated at cost unless the asset is determined to be impaired, at which point the inventory is written down to fair value as required by Accounting Standards Codification (“ASC”) 360-10, Property, Plant and Equipment (“ASC 360-10”). Inventory includes the costs of land acquisition, land development, home construction, capitalized interest, real estate taxes, capitalized direct overhead costs incurred during development and home construction that benefit the entire community, less impairments, if any. Land and development costs are typically allocated and transferred to homes under construction when construction begins. Home construction costs are accumulated on a per-home basis, while selling and marketing costs are expensed as incurred. Cost of home closings includes the specific construction costs of the home and all related allocated land acquisition, land development and other common costs (both incurred and estimated to be incurred) that are allocated based upon the total number of homes expected to be closed in each community or phase. Any changes to the estimated total development costs of a community or phase are allocated to the remaining homes in the community or phase. When a home closes, we may have incurred costs for goods and services that have not yet been paid. An accrued liability to capture such obligations is recorded in connection with the home closing and charged directly to Cost of home closings.

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

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

All of our land inventory and related real estate assets are reviewed for recoverability, as our inventory is considered “long-lived” in accordance with GAAP. Impairment charges are recorded to write down an asset to its estimated fair value if the undiscounted cash flows expected to be generated by the asset are lower than its carrying amount. Our determination of fair value is based on projections and estimates. Changes in these expectations may lead to a change in the outcome of our impairment analysis, and actual results may also differ from our assumptions. Such an analysis is conducted if there is an indication of a decline in value of our land and real estate assets. If an impairment of a community is required, the impairment charges are allocated to each lot on a straight-line basis.

Deposits. Deposits paid for land options and purchase contracts are recorded and classified as Deposits on real estate under option or contract until the related land is purchased. Deposits are reclassified as a component of real estate inventory at the time the deposit is applied to the acquisition price of the land based on the terms of the underlying agreements. To the extent they are non-refundable, deposits are charged to expense if the land acquisition contract is terminated or no longer considered probable. Since our acquisition contracts typically do not require specific performance, we do not consider such contracts to be contractual obligations to purchase the land and our total exposure under such contracts is limited to the loss of the non-refundable deposits and any ancillary capitalized costs. Our deposits on real estate under option or contract were $48.9 million and $59.9 million as of June 30, 2018 and December 31, 2017, respectively.

Goodwill. In accordance with ASC 350, Intangibles, Goodwill and Other ("ASC 350"), we analyze goodwill on an annual basis (or whenever indication of impairment exists) through a qualitative assessment to determine whether it is necessary to perform a goodwill impairment test. ASC 350 states that an entity may first assess qualitative factors to determine whether it is necessary to perform a goodwill impairment test. Such qualitative factors include: (1) macroeconomic conditions, such as a deterioration in general economic conditions, (2) industry and market considerations such as deterioration in the environment in which the entity operates, (3) cost factors such as increases in raw materials and labor costs, and (4) overall financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earnings. If the qualitative analysis determines that additional impairment testing is required, impairment testing in accordance with ASC 350 would be initiated. We continually evaluate our qualitative inputs to assess whether events and circumstances have occurred that indicate the goodwill balance may not be recoverable.

Off-Balance Sheet Arrangements - Joint Ventures. We may participate in land development joint ventures as a means of accessing larger parcels of land and lot positions, expanding our market opportunities, managing our risk profile and leveraging our capital base. See Note 4 for additional discussion of our investments in unconsolidated entities.

Off-Balance Sheet Arrangements - Other. In the normal course of business, we may acquire lots from various development entities pursuant to option and purchase agreements. The purchase price generally approximates the market price at the date the contract is executed (with possible future escalators). See Note 3 for additional information on off-balance sheet arrangements.

Surety Bonds and Letters of Credit. We provide surety bonds or letters of credit in support of our obligations relating to the development of our projects and other corporate purposes. Surety bonds are generally posted in lieu of letters of credit or cash deposits. The amount of these obligations outstanding at any time varies depending on the stage and level of completion of our development activities. Bonds are generally not released until all development activities under the bond are complete. In the event a bond or letter of credit is drawn upon, we would be obligated to reimburse the issuer for any amounts advanced under the bond or letter of credit. We believe it is unlikely that any significant amounts of these bonds or letters of credit will be drawn upon.

The table below outlines our surety bond and letter of credit obligations (in thousands):

	As of			
	June 30, 2018		December 31, 2017	
	Outstanding	Estimated work remaining to complete	Outstanding	Estimated work remaining to complete
Sureties:				
Sureties related to owned projects and lots under contract	$345,297	$ 160,981	$296,387	$ 120,320
Total Sureties	$345,297	$ 160,981	$296,387	$ 120,320
Letters of Credit ("LOCs"):				
LOCs for land development	74,254	N/A	70,922	N/A
LOCs for general corporate operations	3,750	N/A	3,750	N/A
Total LOCs	$78,004	N/A	$74,672	N/A

Accrued Liabilities. Accrued liabilities at June 30, 2018 and December 31, 2017 consisted of the following (in thousands):

	As of	
	June 30, 2018	December 31, 2017
Accruals related to real estate development and construction activities	$65,468	$53,522
Payroll and other benefits	39,559	58,186
Accrued interest	13,404	15,369
Accrued taxes	15,218	14,067
Warranty reserves	23,659	23,328
Other accruals	16,462	16,604
Total	$173,770	$181,076

Revenue Recognition. In accordance with ASC 606 Revenue from Contracts with Customers, we apply the following steps in determining the timing and amount of revenue to recognize: (1) identify the contract with our customer; (2) identify the performance obligation(s) in the contract; (3) determine the transaction price; (4) allocate the transaction price to the performance obligations in the contract, if applicable; and (5) recognize revenue when (or as) we satisfy the performance obligation. The performance obligation and subsequent revenue recognition for our three sources of revenue are outlined below:

- Revenue from closings of residential real estate is recognized when closings have occurred, the risks and rewards of ownership are transferred to the buyer, and we have no continuing involvement with the property, which is generally upon the close of escrow. Revenue is reported net of any discounts and incentives.
- Revenue from land sales is recognized when a significant down payment is received, title passes and collectability of the receivable is reasonably assured, and we have no continuing involvement with the property, which is generally upon the close of escrow.
- Revenue from financial services is recognized when closings have occurred and all financial services have been rendered, which is generally upon the close of escrow.

Revenue expected to be recognized in any future year related to remaining performance obligations (if any) and contract liabilities expected to be recognized as revenue, excluding revenue pertaining to contracts that have an original expected duration of one year or less, is not material. Our three sources of revenue are disaggregated by type in the accompanying unaudited consolidated income statements.

Warranty Reserves. We provide home purchasers with limited warranties against certain building defects and we have certain obligations related to those post-construction warranties for closed homes. The specific terms and conditions of these limited warranties vary by state, but overall the nature of the warranties include a complete workmanship and materials warranty typically during the first one to two years after the close of the home and a structural warranty that typically extends up to 10 years subsequent to the close of the home. With the assistance of an actuary, we have estimated the reserves for the structural warranty based on the number of homes still under warranty and historical data and trends for our communities. We also use industry data with respect to similar product types and geographic areas in markets where our experience is incomplete to draw a meaningful conclusion. We regularly review our warranty reserves and adjust them, as necessary, to reflect changes in trends as information becomes available. Included in the warranty reserve balances at June 30, 2018 and December 31, 2017 reflected in the table below are case-specific reserves for three warranty matters related to (1) alleged stucco defects in Florida; (2) a potentially faulty solar component in various locations provided by a bankrupt manufacturer; and (3) a foundation design matter affecting a single community in Texas.

A summary of changes in our warranty reserves follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Balance, beginning of period	$23,812	$22,477	$23,328	$22,660
Additions to reserve from new home deliveries	4,146	4,310	7,553	8,125
Warranty claims	(4,299)	(3,167)	(7,222)	(7,165)
Adjustments to pre-existing reserves	—	—	—	—
Balance, end of period	$23,659	$23,620	$23,659	$23,620

Warranty reserves are included in Accrued liabilities on the accompanying unaudited consolidated balance sheets, and additions and adjustments to the reserves, if any, are included in Cost of home closings within the accompanying unaudited consolidated income statements. These reserves are intended to cover costs associated with our contractual and statutory warranty obligations, which include, among other items, claims involving defective workmanship and materials. We believe that our total reserves, coupled with our contractual relationships and rights with our trade partners and the general liability insurance we maintain, are sufficient to cover our general warranty obligations. However, as unanticipated changes in legal, weather, environmental or other conditions could have an impact on our actual warranty costs, future costs could differ significantly from our estimates.

We have received claims related to stucco installation from homeowners in certain Florida communities and we established reserves to cover our anticipated exposure related to the repairs based on the information available to us as of June 30, 2018. Our review of the stucco related matter is ongoing and our estimate of future costs of repairs is based on our judgment, various assumptions and internal data. Due to the degree of judgment and the potential for variability in our underlying assumptions and data, as we obtain additional information, we may revise our estimate. As of June 30, 2018, after taking into account potential recovery under our general liability insurance policies and potential recoveries from the contractors involved and their insurers, we believe our reserves are sufficient to cover the repairs related to the existing stucco claims.

Recent Accounting Pronouncements.

In January 2017, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2017-04, Intangibles - Goodwill and Other (Topic 350), Simplifying the Accounting for Goodwill Impairment ("ASU 2017-04"), which simplifies the accounting for goodwill impairments by eliminating the second step of the goodwill impairment test. Under the new guidance, an impairment loss will reflect the amount by which the carrying amount of a reporting unit exceeds its fair value, not to exceed the carrying amount of goodwill. ASU 2017-04 is effective for us beginning January 1, 2020, with early adoption permitted. We have elected to early adopt ASU 2017-04 effective January 1, 2018 and it did not have a material impact on our financial statements.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"). ASU 2016-15 adds and clarifies guidance on the classification of certain cash receipts and payments in the statement of cash flows, reducing the existing diversity in practice that has resulted from the lack of consistent principles on this topic. ASU 2016-15 was effective for us beginning January

1, 2018. A retrospective transition method was required on adoption and it did not have a material impact on our statement of cash flows.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842) ("ASU 2016-02"), which amends the existing accounting standards for lease accounting, including requiring lessees to recognize most leases with lease terms of greater than twelve months on their balance sheets. ASU 2016-02 will be effective for us beginning January 1, 2019. ASU 2016-02 requires a modified retrospective transition approach for all leases existing at, or entered into after, the date of initial application, with an option to use certain transition relief. We are currently evaluating the impact adopting this guidance will have on our financial statements.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606), (“ASU 2014-09”). ASU 2014-09 requires entities to recognize revenue that depicts 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. We adopted ASU 2014-09 on January 1, 2018 using a modified retrospective method.
The adoption of ASU 2014-09 did not have an impact on the amount or timing of our homebuilding revenues, although forfeited customer deposits, typically an immaterial amount on an annual basis, that were previously included in Other income, net are reported as Home closing revenue in our consolidated statements of operations effective January 1, 2018. Additionally, as a result of the adoption of ASU 2014-09, there was an immaterial adjustment to our opening balance of Retained earnings with respect to the timing of expenses resulting from ceasing the capitalization of certain selling costs we incur as part of the selling process. The majority of these previously capitalized costs were allocated to either Real estate or Property and equipment, net on our opening 2018 consolidated balance sheet, with an immaterial amount recognized as a cumulative effect adjustment to the opening balance of retained earnings.
As of and for the three and six months ended June 30, 2018 the adoption of ASU 2014-09 did not have a material impact on our balance sheet, net earnings, stockholders' equity or our statement of cash flows. The comparative information has not been restated and continues to be reported under the accounting standards in effect for those periods.
NOTE 2 — REAL ESTATE AND CAPITALIZED INTEREST
Real estate consists of the following (in thousands):

	As of June 30, 2018	December 31, 2017
Homes under contract under construction (1)	$715,373	$566,474
Unsold homes, completed and under construction (1)	562,435	516,577
Model homes (1)	138,441	142,026
Finished home sites and home sites under development (2)	1,453,798	1,506,303
Total	$2,870,047	$2,731,380

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

(2) Includes raw land, land held for development and land held for sale, less impairments, if any. Land held for development primarily reflects land and land development costs related to land where development activity is not currently underway but is expected to begin in the future. For these parcels, we may have chosen not to currently develop certain land holdings as they typically represent a portion or phases of a larger land parcel that we plan to build out over several years. We do not capitalize interest for inactive assets, and all ongoing costs of land ownership (i.e. property taxes, homeowner association dues, etc.) are expensed as incurred.

Subject to sufficient qualifying assets, we capitalize our development period interest costs incurred in connection with our real estate development and construction activities. Capitalized interest is allocated to active real estate when incurred and charged to cost of closings when the related property is delivered. A summary of our capitalized interest is as follows (in thousands):

	Three Months Ended June 30, 2018	Three Months Ended June 30, 2017	Six Months Ended June 30, 2018	Six Months Ended June 30, 2017
Capitalized interest, beginning of period	$81,828	$70,885	$78,564	$68,196
Interest incurred	21,374	19,280	42,243	37,175
Interest expensed	(44)	(1,620)	(180)	(2,445)

Interest amortized to cost of home and land closings	(18,715)	(16,218)	(36,184)	(30,599)
Capitalized interest, end of period	$84,443	$72,327	$84,443	$72,327

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

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

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

In order to determine if we are the primary beneficiary, we must first assess whether we have the ability to control the activities of the VIE that most significantly impact its economic performance. Such activities include, but are not limited to: 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 of the VIE to acquire additional land or dispose of land not under contract with Meritage; and the ability to change or amend the existing option contract with the VIE. If we are not determined to control such activities, we are not considered the primary beneficiary of the VIE. If we do have the ability to control such activities, we will continue our analysis to determine if we are also expected to absorb a potentially significant amount of the VIE's losses or, if no party absorbs the majority of such losses, if we will benefit from a potentially significant amount of the VIE's expected gains.

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

The table below presents a summary of our lots under option at June 30, 2018 (dollars in thousands):

	Projected Number of Lots	Purchase Price	Option/ Earnest Money Deposits–Cash	
Purchase and option contracts recorded on balance sheet as Real estate not owned	228	$38,864	$ 3,886	
Option contracts — non-refundable deposits, committed (1)	2,907	219,491	26,432	
Purchase contracts — non-refundable deposits, committed (1)	5,854	229,643	18,353	
Purchase and option contracts —refundable deposits, committed	866	33,091	1,021	
Total committed	9,855	521,089	49,692	
Purchase and option contracts — refundable deposits, uncommitted (2)	10,728	271,343	3,074	
Total lots under contract or option	20,583	$792,432	$ 52,766	
Total purchase and option contracts not recorded on balance sheet (3)	20,355	$753,568	$ 48,880	(4)

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

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

(3) Except for our specific performance contracts recorded on our balance sheet as Real estate not owned, none of our purchase or option contracts require us to purchase lots.

(4) Amount is reflected on our consolidated balance sheet in Deposits on real estate under option or contract as of June 30, 2018.

Generally, our options to purchase lots remain effective so long as we purchase a pre-established minimum number of lots each month or quarter, as determined by the respective agreement. Although the pre-established number is typically structured to approximate our expected rate of home construction starts and sales absorptions, during a weakened homebuilding market, we may purchase lots at an absorption level that exceeds our sales and home starts pace in order to meet the pre-established minimum number of lots or we will work to restructure our original contract to terms that more accurately reflect our revised orders pace expectations.

NOTE 4 - INVESTMENTS IN UNCONSOLIDATED ENTITIES

We may enter into land development joint ventures as a means of accessing larger parcels of land, expanding our market opportunities, managing our risk profile and leveraging our capital base. While purchasing land through a joint venture can be beneficial, currently we do not view joint ventures as critical to the success of our homebuilding operations. Based on the structure of each joint venture, it may or may not be consolidated into our results. Our joint venture partners are generally other homebuilders, land sellers or other real estate investors. We generally do not have a controlling interest in these ventures, which means our joint venture partners could cause the venture to take actions we disagree with, or fail to take actions we believe should be undertaken, including the sale of the underlying property to repay debt or recoup all or part of the partners' investments. As of June 30, 2018, we had three active equity-method land ventures.

As of June 30, 2018, we also participated in one mortgage joint venture, which is engaged in mortgage activities and provides services to both our homebuyers as well as other buyers. Our investment in this mortgage joint venture as of June 30, 2018 and December 31, 2017 was $1.6 million and $2.2 million, respectively.

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

	As of	
	June 30, 2018	December 31, 2017
Assets:		
Cash	$8,441	$ 8,942
Real estate	57,553	55,552
Other assets	3,451	4,323
Total assets	$69,445	$ 68,817
Liabilities and equity:		
Accounts payable and other liabilities	$6,492	$ 7,516
Notes and mortgages payable	26,572	25,194
Equity of:		
Meritage (1)	14,736	14,521
Other	21,645	21,586
Total liabilities and equity	$69,445	$ 68,817

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Revenue	$9,982	$13,430	$17,314	$21,029
Costs and expenses	(3,408)	(6,106)	(7,343)	(10,586)
Net earnings of unconsolidated entities	$6,574	$7,324	$9,971	$10,443
Meritage's share of pre-tax earnings[(1) (2)]	$3,368	$4,068	$5,978	$7,250

(1) Balance represents Meritage's interest, as reflected in the financial records of the respective joint ventures. This balance may differ from the balance reported in our consolidated financial statements due to the following reconciling items: (i) timing differences for revenue and distributions recognition, (ii) step-up basis and corresponding amortization, (iii) capitalization of interest on qualified assets, (iv) income deferrals as discussed in Note (2) below and (v) the cessation of allocation of losses from joint ventures in which we have previously written down our investment balance to zero and where we have no commitment to fund additional losses.

(2) Our share of pre-tax earnings is recorded in Earnings from financial services unconsolidated entities and other, net and (Loss)/earnings from other unconsolidated entities, net on our unaudited consolidated income statements and excludes joint venture profit related to lots we purchased from the joint ventures, if any. Such profit is deferred until homes are delivered by us and title passes to a homebuyer.

Our total investment in all of these joint ventures is $16.6 million and $17.1 million as of June 30, 2018 and December 31, 2017, respectively. We believe these ventures are in compliance with their respective debt agreements, if applicable, and such debt is non-recourse to us.

NOTE 5 — LOANS PAYABLE AND OTHER BORROWINGS

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

	As of June 30, 2018	December 31, 2017
Other borrowings, real estate notes payable [(1)]	$16,552	$ 17,354
$780 million unsecured revolving credit facility with interest approximating LIBOR (approximately 2.09% at June 30, 2018) plus 1.75% or Prime (5.00% at June 30, 2018) plus 0.75%	—	—
Total	$16,552	$ 17,354

(1) Reflects balance of non-recourse notes payable in connection with land purchases, with interest rates ranging from 0% to 8%.

The Company entered into an amended and restated unsecured revolving credit facility ("Credit Facility") in 2014 that has been amended from time to time. In June 2018 the aggregate commitment was increased to $780.0 million, and the maturity date extended to July 2022. The accordion feature was also refreshed permitting the size of the facility to increase to a maximum of $880.0 million. Borrowings under the Credit Facility are unsecured but availability is subject to, among other things, a borrowing base. The Credit Facility also contains certain financial covenants, including (a) a minimum tangible net worth requirement of $1.1 billion (which amount is subject to increase over time based on subsequent earnings and proceeds from equity offerings), and (b) a maximum leverage covenant that prohibits the leverage ratio (as defined therein) from exceeding 60%. In addition, we are required to maintain either (i) an interest coverage ratio (EBITDA to interest expense, as defined therein) of at least 1.50 to 1.00 or (ii) liquidity (as defined therein) of an amount not less than our consolidated interest incurred during the trailing 12 months.

We had no outstanding borrowings under the Credit Facility as of June 30, 2018 and December 31, 2017. During the three and six months ended June 30, 2018, we had $285.0 million in gross borrowings and repayments. During the three months ended June 30, 2017 we had $85.0 million of gross borrowings and $145.0 million of repayments. During the six months ended June 30, 2017, we had $245.0 million of gross borrowings and $260.0 million of repayments. As of June 30, 2018, we had outstanding letters of credit issued under the Credit Facility totaling $78.0 million, leaving $702.0 million available under the Credit Facility to be drawn.

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NOTE 6 — SENIOR NOTES, NET

Senior notes, net consist of the following (in thousands):

	As of June 30, 2018	December 31, 2017
4.50% senior notes due 2018	$—	$175,000
7.15% senior notes due 2020. At June 30, 2018 and December 31, 2017 there was approximately $995 and $1,280 in net unamortized premium, respectively.	300,995	301,280
7.00% senior notes due 2022	300,000	300,000
6.00% senior notes due 2025. At June 30, 2018 there was approximately $5,727 in net unamortized premium. (1)	405,727	200,000
5.125% senior notes due 2027	300,000	300,000
Net debt issuance costs	(12,017)	(9,830)
Total	$1,294,705	$1,266,450

(1) $200.0 million of the total $400.0 million 6.00% Senior Notes due 2025 outstanding at December 31, 2017 was issued at par and had no unamortized premium.

In March 2018, the Company completed an offering of $200.0 million aggregate principal amount of 6.00% Senior Notes due 2025 (the "Additional Notes"). The Additional Notes were issued as an add-on to the existing $200.0 million of 6.00% Senior Notes due 2025 that were issued in June 2015 which resulted in a combined $400.0 million aggregate principal amount of 6.00% Senior Notes due 2025 outstanding as of June 30, 2018. The Additional Notes were issued at a premium of 103% of the principal amount and the net proceeds were used to repay outstanding borrowings under the Credit Facility, which included borrowings used for the redemption of the Company's $175.0 million of 4.50% Senior Notes that were due to mature on March 1, 2018.

The indentures for all of our senior notes contain covenants including, among others, limitations on the amount of secured debt we may incur, and limitations on sale and leaseback transactions and mergers. We believe we are in compliance with all such covenants as of June 30, 2018.

Obligations to pay principal and interest on the senior notes are guaranteed by substantially all of our wholly-owned subsidiaries (each a “Guarantor” and, collectively, the “Guarantor Subsidiaries”), each of which is directly or indirectly 100% owned by Meritage Homes Corporation. Such guarantees are full and unconditional, and joint and several. In the event of a sale or other disposition of all of the assets of any Guarantor, by way of merger, consolidation or otherwise, or a sale or other disposition of all of the equity interests of any Guarantor then held by Meritage and its subsidiaries, then that Guarantor may be released and relieved of any obligations under its note guarantee. There are no significant restrictions on our ability or the ability of any Guarantor to obtain funds from their respective subsidiaries, as applicable, by dividend or loan. We do not provide separate financial statements of the Guarantor Subsidiaries because Meritage (the parent company) has no independent assets or operations and the guarantees are full and unconditional and joint and several. Subsidiaries of Meritage Homes Corporation that are non-guarantor subsidiaries are, individually and in the aggregate, minor.

NOTE 7 — FAIR VALUE DISCLOSURES

We account for non-recurring fair value measurements of our non-financial assets and liabilities in accordance with ASC 820-10 Fair Value Measurement ("ASC 820"). This guidance defines fair value, establishes a framework for measuring fair value and addresses required 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 which 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.

Financial Instruments: The fair value of our fixed-rate debt is derived from quoted market prices by independent dealers (level 2 inputs as per the discussion above) and is as follows (in thousands):

	As of			
	June 30, 2018		December 31, 2017	
	Aggregate Principal	Estimated Fair Value	Aggregate Principal	Estimated Fair Value
4.50% senior notes	N/A	N/A	$175,000	$175,228
7.15% senior notes	$300,000	$317,250	$300,000	$326,250
7.00% senior notes	$300,000	$323,250	$300,000	$337,500
6.00% senior notes	$400,000	$405,000	$200,000	$214,000
5.125% senior notes	$300,000	$277,500	$300,000	$305,250

Due to the short-term nature of other financial assets and liabilities, including our Loans payable and other borrowings, we consider the carrying amounts of our other short-term financial instruments to approximate fair value.

NOTE 8 — EARNINGS PER SHARE

Basic and diluted earnings per common share were calculated as follows (in thousands, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Basic weighted average number of shares outstanding	40,647	40,317	40,568	40,248
Effect of dilutive securities:				
Convertible debt [1]	—	1,991	—	2,083
Unvested restricted stock	517	473	625	505
Diluted average shares outstanding	41,164	42,781	41,193	42,836
Net earnings as reported	$53,838	$41,580		