MDC HOLDINGS INC
Form 10-Q
November 01, 2016
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2016

OR

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

Commission File No. 1-8951

M.D.C. HOLDINGS, INC.

(Exact name of Registrant as specified in its charter)

Delaware	**84-0622967**
(State or other jurisdiction	**(I.R.S.**

of incorporation or organization)	**employer identification no.)**

4350 South Monaco Street, Suite 500 Denver, Colorado	**80237**
(Address of principal executive offices)	**(Zip code)**

(303) 773-1100

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, non-accelerated filer, or a smaller reporting company. See definition of “large accelerated filer,” “accelerated filer,” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

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

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

As of October 31, 2016, 49,033,981 shares of M.D.C. Holdings, Inc. common stock were outstanding.

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M.D.C. HOLDINGS, INC.

FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 2016

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PART I

ITEM 1. Unaudited Consolidated Financial Statements

M.D.C. HOLDINGS, INC.

Consolidated Balance Sheets.

	September 30, 2016	December 31, 2015
	(Dollars in thousands, except per share amounts) (Unaudited)	
ASSETS		
Homebuilding:		
Cash and cash equivalents	$129,278	$144,342
Marketable securities	57,116	92,387
Restricted cash	4,621	3,750
Trade and other receivables	43,082	23,314
Inventories:		
Housing completed or under construction	976,372	747,036
Land and land under development	870,733	1,016,926
Total inventories	1,847,105	1,763,962
Property and equipment, net	28,749	28,226
Deferred tax asset, net	85,128	99,107
Metropolitan district bond securities (related party)	29,132	25,911
Prepaid and other assets	66,195	65,394
Total homebuilding assets	2,290,406	2,246,393
Financial Services:		
Cash and cash equivalents	34,180	36,646
Marketable securities	22,105	11,307
Mortgage loans held-for-sale, net	117,989	115,670
Other assets	9,590	5,883
Total financial services assets	183,864	169,506
Total Assets	$2,474,270	$2,415,899
LIABILITIES AND EQUITY		
Homebuilding:		
Accounts payable	$54,117	$40,472
Accrued liabilities	122,227	122,886

Revolving credit facility	15,000	15,000
Senior notes, net	841,359	840,524
Total homebuilding liabilities	1,032,703	1,018,882
Financial Services:		
Accounts payable and accrued liabilities	56,934	52,114
Mortgage repurchase facility	92,011	88,611
Total financial services liabilities	148,945	140,725
Total Liabilities	1,181,648	1,159,607
Stockholders' Equity		
Preferred stock, $0.01 par value; 25,000,000 shares authorized; none issued or outstanding	-	-
Common stock, $0.01 par value; 250,000,000 shares authorized; 49,033,981 and 48,888,424 issued and outstanding at September 30, 2016 and December 31, 2015, respectively	490	489
Additional paid-in-capital	922,132	915,746
Retained earnings	350,414	324,342
Accumulated other comprehensive income	19,586	15,715
Total Stockholders' Equity	1,292,622	1,256,292
Total Liabilities and Stockholders' Equity	$2,474,270	$2,415,899

The accompanying Notes are an integral part of these Unaudited Consolidated Financial Statements.

M.D.C. HOLDINGS, INC.

Consolidated Statements of Operations and Comprehensive Income

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands, except per share amounts) (Unaudited)			
Homebuilding:				
Home sale revenues	$575,722	$454,740	$1,541,337	$1,293,457
Land sale revenues	2,290	906	4,930	1,816
Total home and land sale revenues	578,012	455,646	1,546,267	1,295,273
Home cost of sales	(481,511)	(375,948)	(1,287,373)	(1,079,609)
Land cost of sales	(2,318)	(819)	(4,197)	(1,944)
Inventory impairments	(4,700)	(4,351)	(6,300)	(4,701)
Total cost of sales	(488,529)	(381,118)	(1,297,870)	(1,086,254)
Gross margin	89,483	74,528	248,397	209,019
Selling, general and administrative expenses	(61,904)	(57,444)	(182,621)	(162,757)
Interest and other income	1,869	838	5,358	5,412
Other expense	(1,558)	(350)	(2,463)	(2,539)
Other-than-temporary impairment of marketable securities	(215)	(2,176)	(934)	(2,176)
Homebuilding pretax income	27,675	15,396	67,737	46,959
Financial Services:				
Revenues	17,408	12,841	44,248	34,852
Expenses	(7,955)	(5,464)	(21,739)	(15,830)
Interest and other income	1,035	885	2,648	2,885
Other-than-temporary impairment of marketable securities	(111)	-	(111)	-
Financial services pretax income	10,377	8,262	25,046	21,907
Income before income taxes	38,052	23,658	92,783	68,866
Provision for income taxes	(11,693)	(8,880)	(29,948)	(25,670)
Net income	$26,359	$14,778	$62,835	$43,196
Other comprehensive income (loss) related to available for sale securities, net of tax	1,028	(226)	3,871	722
Comprehensive income	$27,387	$14,552	$66,706	$43,918
Earnings per share:				
Basic	$0.54	$0.30	$1.28	$0.88
Diluted	$0.54	$0.30	$1.28	$0.88
Weighted average common shares outstanding				
Basic	48,854,412	48,785,973	48,844,613	48,756,265

Diluted	49,009,949	49,070,291	48,855,014	48,982,975
Dividends declared per share	$0.25	$0.25	$0.75	$0.75

The accompanying Notes are an integral part of these Unaudited Consolidated Financial Statements.

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M.D.C. HOLDINGS, INC.

Consolidated Statements of Cash Flows

	Nine Months Ended September 30,	
	2016	2015
	(Dollars in thousands) (Unaudited)	
Operating Activities:		
Net income	$62,835	$43,196
Adjustments to reconcile net income to net cash used in operating activities:		
Stock-based compensation expense	6,636	6,589
Depreciation and amortization	3,702	3,084
Inventory impairments	6,300	4,701
Other-than-temporary impairment of marketable securities	1,045	2,176
Loss (gain) on sale of marketable securities	(911)	126
Amortization of discount / premiums on marketable debt securities, net	-	100
Deferred income tax expense	11,357	24,782
Net changes in assets and liabilities:		
Restricted cash	(871)	(1,984)
Trade and other receivables	(21,679)	(575)
Mortgage loans held-for-sale	(2,319)	19,759
Housing completed or under construction	(229,739)	(89,841)
Land and land under development	141,131	(25,805)
Other assets	(4,573)	(8,072)
Accounts payable and accrued liabilities	18,183	(4,722)
Net cash used in operating activities	(8,903)	(26,486)
Investing Activities:		
Purchases of marketable securities	(28,272)	(46,886)
Maturities of marketable securities	-	1,510
Sales of marketable securities	56,873	94,910
Purchases of property and equipment	(3,865)	(830)
Net cash provided by investing activities	24,736	48,704
Financing Activities:		
Advances (payments) on mortgage repurchase facility, net	3,400	(17,067)
Advances on revolving credit facility	-	-
Dividend payments	(36,763)	(36,646)
Proceeds from exercise of stock options	-	665
Net cash used in financing activities	(33,363)	(53,048)
Net decrease in cash and cash equivalents	(17,530)	(30,830)
Cash and cash equivalents:		

Beginning of period	180,988	153,825
End of period	$163,458	$122,995

The accompanying Notes are an integral part of these Unaudited Consolidated Financial Statements.

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M.D.C. HOLDINGS, INC.

Notes to Unaudited Consolidated Financial Statements

1. Basis of Presentation

The Unaudited Consolidated Financial Statements of M.D.C. Holdings, Inc. ("MDC," “the Company," “we,” “us,” or “our” which refers to M.D.C. Holdings, Inc. and its subsidiaries) have been prepared, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). Accordingly, they do not include all information and footnotes required by U.S. generally accepted accounting principles (“GAAP”) for complete financial statements. These statements reflect all normal and recurring adjustments which, in the opinion of management, are necessary to present fairly the financial position, results of operations and cash flows of MDC at September 30, 2016 and for all periods presented. These statements should be read in conjunction with MDC’s Consolidated Financial Statements and Notes thereto included in MDC’s Annual Report on Form 10-K for the year ended December 31, 2015.

2. Recently Issued Accounting Standards

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, *Revenue from Contracts with Customers* ("ASU 2014-09"), which is a comprehensive new revenue recognition model. Under ASU 2014-09, a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods and services. ASU 2014-09 is effective for our interim and annual reporting periods beginning January 1, 2018, and is to be adopted using either a full retrospective or modified retrospective transition method. Early adoption is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. We do not plan to early adopt the guidance and are currently evaluating the method of adoption and impact the update will have on our consolidated financial statements and related disclosures.

In February 2015, the FASB issued ASU 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis* (“ASU 2015-02”), which amends the consolidation requirements in Accounting Standards Codification (“ASC”) Topic 810, *Consolidation*, primarily related to limited partnerships and variable interest entities. ASU 2015-02 was effective for our interim and annual reporting periods beginning January 1, 2016 and did not have a material impact on our consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments–Overall: Recognition and Measurement of Financial Assets and Financial Liabilities* (“ASU 2016-01”), which makes a number of changes to the current GAAP model, including changes to the accounting for equity investments and financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. Under ASU 2016-01, we will primarily be impacted by the changes to accounting for equity instruments with readily determinable fair values as they will no longer be permitted to be classified as available-for-sale (changes in fair value reported through other comprehensive income) and instead, all changes in fair value will be reported in earnings. ASU 2016-01 is effective for our interim and annual reporting periods beginning January 1, 2018 and is to be applied using a modified retrospective transition method. Early adoption of the applicable guidance from ASU 2016-01 is not permitted. We are currently evaluating the impact the update will have on our consolidated financial statements and related disclosures.

In February 2016, the FASB issued ASU 2016-02, *Leases* (“ASU 2016-02”), which requires a lessee to recognize a right-of-use asset and a corresponding lease liability for virtually all leases. The liability will be equal to the present value of lease payments while the right-of-use asset will be based on the liability, subject to adjustment, such as for initial direct costs. In addition, ASU 2016-02 expands the disclosure requirements for lessees. ASU 2016-02 is effective for our interim and annual reporting periods beginning January 1, 2019 and is to be applied using a modified retrospective transition method. Early adoption is permitted. We do not plan to early adopt the guidance and we are currently evaluating the impact the update will have on our consolidated financial statements and related disclosures.

In March 2016, the FASB issued ASU 2016-09, *Compensation - Stock Compensation: Improvements to Employee Share-Based Payment Accounting* (“ASU 2016-09”), which amends ASC Topic 718, *Compensation – Stock Compensation* (“ASC 718”). The standard is intended to simplify several areas of accounting for share-based compensation arrangements, including the accounting for income taxes, classification of excess tax benefits on the statement of cash flows, forfeitures, statutory tax withholding requirements, classification of awards as either equity or liabilities, and classification of employee taxes paid on the statement of cash flows when an employer withholds shares for tax-withholding purposes. ASU 2016-09 is effective for our interim and annual reporting periods beginning January 1, 2017, and is to be applied using a retrospective transition method. Early adoption is permitted. We do not plan to early adopt the guidance and we are currently evaluating the impact the update will have on our consolidated financial statements and related disclosures.

M.D.C. HOLDINGS, INC.

Notes to Unaudited Consolidated Financial Statements

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* ("ASU 2016-13"), which requires measurement and recognition of expected credit losses for financial assets held. The amendments in ASU 2016-13 eliminate the probable threshold for initial recognition of a credit loss in current GAAP and reflect an entity's current estimate of all expected credit losses. ASU 2016-13 is effective for our interim and annual reporting periods beginning January 1, 2021, and is to be applied using a modified retrospective transition method. Earlier adoption is permitted. We do not plan to early adopt the guidance and we are currently evaluating the impact the update will have on our consolidated financial statements and related disclosures.

In August 2016, the FASB issued ASU 2016-15, S*tatement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (a consensus of the Emerging Issues Task Force)* ("ASU 2016-15"), which amends ASC Topic 230*, Statement of Cash Flows*, to clarify guidance on the classification of certain cash receipts and payments in the statement of cash flows. The amendments in ASU 2016-15 are intended to reduce diversity in practice in how certain transactions are classified in the statement of cash flows. ASU 2016-15 is effective for our interim and annual reporting periods beginning January 1, 2018, and is to be applied using a retrospective transition method. Earlier adoption is permitted. We do not plan to early adopt the guidance and do not believe the guidance will have a material impact on our financial statements upon adoption.

3. Segment Reporting

An operating segment is defined as a component of an enterprise for which discrete financial information is available and is reviewed regularly by the Chief Operating Decision Maker ("CODM"), or decision-making group, to evaluate performance and make operating decisions. We have identified our CODM as two key executives—the Chief Executive Officer and the Chief Operating Officer.

We have identified each homebuilding division as an operating segment. Our homebuilding operating segments have been aggregated into the reportable segments noted below because they are similar in the following regards: (1) economic characteristics; (2) housing products; (3) class of homebuyer; (4) regulatory environments; and (5) methods used to construct and sell homes. Our homebuilding reportable segments are as follows:

West (Arizona, California, Nevada and Washington)

Mountain (Colorado and Utah)
East (Virginia, Florida and Maryland, which includes Pennsylvania and New Jersey)

Our financial services business consists of the operations of the following operating segments: (1) HomeAmerican Mortgage Corporation ("HomeAmerican"); (2) Allegiant Insurance Company, Inc., A Risk Retention Group ("Allegiant"); (3) StarAmerican Insurance Ltd. ("StarAmerican"); (4) American Home Insurance Agency, Inc.; and (5) American Home Title and Escrow Company. Due to its contributions to consolidated pretax income, we consider HomeAmerican to be a reportable segment ("mortgage operations"). The remaining operating segments have been aggregated into one reportable segment ("other") because they do not individually exceed 10 percent of: (1) consolidated revenue; (2) the greater of (a) the combined reported profit of all operating segments that did not report a loss or (b) the positive value of the combined reported loss of all operating segments that reported losses; or (3) consolidated assets.

Corporate is a non-operating segment that develops and implements strategic initiatives and supports our operating divisions by centralizing key administrative functions such as finance, treasury, information technology, insurance, risk management, litigation, and human resources. Corporate also provides the necessary administrative functions to support MDC as a publicly traded company. A portion of the expenses incurred by Corporate are allocated to the homebuilding operating segments based on their respective percentages of assets, and to a lesser degree, a portion of Corporate expenses are allocated to the financial services segments. A majority of Corporate's personnel and resources are primarily dedicated to activities relating to the homebuilding segments, and, therefore, the balance of any unallocated Corporate expenses is included in our homebuilding operations.

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Notes to Unaudited Consolidated Financial Statements

The following table summarizes home and land sale revenues for our homebuilding operations and revenues for our financial services operations.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			
Homebuilding				
West	$284,589	$229,743	$745,995	$624,261
Mountain	192,876	147,166	521,034	428,080
East	100,547	78,737	279,238	242,932
Total home and land sale revenues	$578,012	$455,646	$1,546,267	$1,295,273
Financial Services				
Mortgage operations	$11,294	$7,999	$28,866	$21,752
Other	6,114	4,842	15,382	13,100
Total financial services revenues	$17,408	$12,841	$44,248	$34,852

The following table summarizes pretax income (loss) for our homebuilding and financial services operations:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			
Homebuilding				
West	$18,392	$16,708	$43,830	$40,808
Mountain	18,856	12,849	49,688	35,239
East	(2,267)	(691)	3,600	(1,093)
Corporate	(7,306)	(13,470)	(29,381)	(27,995)
Total homebuilding pretax income	$27,675	$15,396	$67,737	$46,959
Financial Services				
Mortgage operations	$6,723	$5,354	$16,491	$12,243
Other	3,654	2,908	8,555	9,664
Total financial services pretax income	$10,377	$8,262	$25,046	$21,907

Total pretax income	$38,052	$23,658	$92,783	$68,866

The following table summarizes total assets for our homebuilding and financial services operations. The assets in our West, Mountain and East segments consist primarily of inventory while the assets in our Corporate segment primarily include our cash and cash equivalents, marketable securities and deferred tax assets. The assets in our financial services segment consist mostly of cash and cash equivalents, marketable securities and mortgage loans held-for-sale.

	September 30, 2016	December 31, 2015
	(Dollars in thousands)	
Homebuilding assets		
West	$1,083,419	$991,393
Mountain	588,976	536,831
East	285,528	324,457
Corporate	332,483	393,712
Total homebuilding assets	$2,290,406	$2,246,393
Financial services assets		
Mortgage operations	$129,545	$123,176
Other	54,319	46,330
Total financial services assets	$183,864	$169,506
Total assets	$2,474,270	$2,415,899

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Notes to Unaudited Consolidated Financial Statements

4. Earnings Per Share

ASC Topic 260, *Earnings Per Share* ("ASC 260"), requires a company that has participating security holders (for example, holders of unvested restricted stock that has nonforfeitable dividend rights) to utilize the two-class method for calculating earnings per share ("EPS") unless the treasury stock method results in lower EPS. The two-class method is an allocation of earnings/(loss) between the holders of common stock and a company's participating security holders. Under the two-class method, earnings/(loss) for the reporting period are allocated between common shareholders and other security holders based on their respective rights to receive distributed earnings (i.e., dividends) and undistributed earnings (i.e., net income/(loss)). Our common shares outstanding are comprised of shareholder owned common stock and participating security holders consisting of shareholders of unvested restricted stock. Basic EPS is calculated by dividing income or loss attributable to common stockholders by the weighted average number of shares of common stock outstanding, excluding participating shares in accordance with ASC 260. To calculate diluted EPS, basic EPS is further adjusted to include the effect of potential dilutive stock options outstanding. The table below shows basic and diluted EPS calculations:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands, except per share amounts)			
Numerator				
Net income	$26,359	$14,778	$62,835	$43,196
Less: distributed earnings allocated to participating securities	(45)	(25)	(124)	(73)
Less: undistributed earnings allocated to participating securities	(49)	(6)	(83)	(15)
Net income attributable to common stockholders (numerator for basic earnings per share)	26,265	14,747	62,628	43,108
Add back: undistributed earnings allocated to participating securities	49	6	83	15
Less: undistributed earnings reallocated to participating securities	(49)	(6)	(83)	(15)
Numerator for diluted earnings per share under two class method	$26,265	$14,747	$62,628	$43,108
Denominator				
Weighted-average common shares outstanding	48,854,412	48,785,973	48,844,613	48,756,265
Add: dilutive effect of stock options	155,537	284,318	10,401	226,710

Denominator for diluted earnings per share under two class method	49,009,949	49,070,291	48,855,014	48,982,975
Basic Earnings Per Common Share	$0.54	$0.30	$1.28	$0.88
Diluted Earnings Per Common Share	$0.54	$0.30	$1.28	$0.88

Diluted EPS for the three and nine months ended September 30, 2016 excluded options to purchase approximately 5.3 million and 6.4 million shares, respectively, of common stock because the effect of their inclusion would be anti-dilutive. For the same periods in 2015, diluted EPS excluded options to purchase approximately 3.4 million and 3.9 million shares, respectively.

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Notes to Unaudited Consolidated Financial Statements

5. Accumulated Other Comprehensive Income

The following table sets forth our changes in accumulated other comprehensive income (“AOCI”):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			
Unrealized gains (losses) on available-for-sale marketable securities [1] :				
Beginning balance	$5,344	$1,589	$3,657	$2,775
Other comprehensive income (loss) before reclassifications	1,156	(2,853)	2,559	(3,753)
Amounts reclassified from AOCI [2]	(201)	1,714	83	1,428
Ending balance	$6,299	$450	$6,299	$450
Unrealized gains on available-for-sale metropolitan district bond securities [1] :				
Beginning balance	$13,214	$9,814	$12,058	$7,680
Other comprehensive income before reclassifications	73	913	1,229	3,047
Ending balance	$13,287	$10,727	$13,287	$10,727
Total ending AOCI	$19,586	$11,177	$19,586	$11,177

(1) All amounts net-of-tax.
(2) See separate table below for details about these reclassifications

The following table sets forth the activity related to reclassifications out of accumulated other comprehensive income related to available for sale securities:

	Three Months Ended	Nine Months Ended

Affected Line Item in the Statements of Operations	September 30,		September 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			
Homebuilding: Interest and other income	$555	$(620)	$817	$(495)
Homebuilding: Other-than-temporary impairment of marketable securities	(215)	(2,176)	(934)	(2,176)
Financial services: Interest and other income	94	31	94	368
Financial services: Other than temporary impairment of marketable securities	(111)	-	(111)	-
Income before income taxes	323	(2,765)	(134)	(2,303)
Provision for income taxes	(122)	1,051	51	875
Net income	$201	$(1,714)	$(83)	$(1,428)

6. Fair Value Measurements

ASC Topic 820, *Fair Value Measurements* (“ASC 820”), defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. ASC 820 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs, other than quoted prices in active markets, that are either directly or indirectly observable; and Level 3, defined as unobservable inputs for which little or no market data exists, therefore requiring an entity to develop its own assumptions.

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M.D.C. HOLDINGS, INC.

Notes to Unaudited Consolidated Financial Statements

The following table sets forth the fair values and methods used for measuring the fair values of financial instruments on a recurring basis:

Financial Instrument	Hierarchy	Fair Value September 30, 2016	December 31, 2015
		(Dollars in thousands)	
Marketable equity securities (available-for-sale)	Level 1	$79,221	$103,694
Mortgage loans held-for-sale, net	Level 2	$117,989	$115,670
Metropolitan district bond securities (related party) (available-for-sale)	Level 3	$29,132	$25,911

The following methods and assumptions were used to estimate the fair value of each class of financial instruments as of September 30, 2016 and December 31, 2015.

Cash and cash equivalents, restricted cash, trade and other receivables, prepaid and other assets, accounts payable, accrued liabilities and borrowings on our revolving credit facility. Fair value approximates carrying value.

Marketable securities. As of September 30, 2016 and December 31, 2015, we only held marketable equity securities. However, during 2015, we also held marketable debt securities. Our equity securities consist of holdings in corporate equities, preferred stock, exchange traded funds and holdings in mutual fund securities (which are primarily invested in debt securities). Our debt securities consisted primarily of fixed and floating rate interest earning debt securities, which included, among others, United States government and government agency debt and corporate debt. As of September 30, 2016 and December 31, 2015, all of our equity securities were treated as available-for-sale investments and as such, are recorded at fair value with all changes in fair value initially recorded through AOCI, subject to an assessment to determine if an unrealized loss, if applicable, is other-than-temporary.

Each quarter we assess all of our securities in an unrealized loss position for a potential other-than-temporary impairment (“OTTI”). If the unrealized loss is determined to be other-than-temporary, an OTTI is recorded to the other-than-temporary impairment of marketable securities line in the homebuilding section of our consolidated statements of operations and comprehensive income. During the three months and nine months ended September 30, 2016, we recorded pretax OTTIs of $0.3 million and $1.0 million, respectively, for certain of our equity securities that were in an unrealized loss position as of the end of each respective period, compared to $2.2 million for both the three and nine months ended September 30, 2015.

The following tables set forth the cost and fair value of our marketable equity securities:

	September 30, 2016			
	Amortized Cost	OTTI	Net Amortized Cost	Fair Value
	(Dollars in thousands)			
Homebuilding equity securities	$48,225	$(958)	$ 47,267	$57,116
Financial services equity securities	21,905	(112)	21,793	22,105
Total marketable equity securities	$70,130	$(1,070)	$ 69,060	$79,221

	December 31, 2015			
	Amortized Cost	OTTI	Net Amortized Cost	Fair Value
	(Dollars in thousands)			
Homebuilding equity securities	$89,738	$(3,969)	$ 85,769	$92,387
Financial services equity securities	12,026	-	12,026	11,307
Total marketable equity securities	$101,764	$(3,969)	$ 97,795	$103,694

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As of September 30, 2016 and December 31, 2015, our marketable equity securities were in net unrealized gain positions totaling $10.2 million and $5.9 million, respectively. Our individual marketable equity securities that were in unrealized loss positions, excluding those that were impaired as part of any OTTI, aggregated to an unrealized loss of $0.5 million and $0.9 million as of September 30, 2016 and December 31, 2015, respectively. The table below sets forth the aggregated unrealized losses for individual equity securities that were in unrealized loss positions but did not have OTTIs recognized. We do not believe the decline in the value of these marketable securities as of September 30, 2016 is other-than-temporary.

	September 30, 2016			December 31, 2015		
	Number of Securities in an Unrealized Loss Position	Aggregate Unrealized Loss Position	Aggregate Fair Value of Securities in an Unrealized Loss Position	Number of Securities in an Unrealized Loss Position	Aggregate Unrealized Loss Position	Aggregate Fair Value of Securities in an Unrealized Loss Position
	(Dollars in thousands)					
Marketable equity securities	2	$ (450)	$ 2,548	4	$ (882)	$ 6,116

The table below sets forth gross realized gains and losses from the sale of available-for-sale marketable securities. We record the net amount of these gains and losses to either other expense or interest and other income, dependent upon whether there is a net realized loss or gain, respectively, in the homebuilding section or financial services section of our consolidated statements of operations and comprehensive income.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			

Gross realized gains on sales of available-for-sale securities				
Equity securities	$740	$980	$2,210	$1,855
Debt securities	-	42	-	413
Total	$740	$1,022	$2,210	$2,268
Gross realized losses on sales of available-for-sale securities				
Equity securities	$(91)	$(1,604)	$(1,299)	$(2,161)
Debt securities	-	(6)	-	(233)
Total	$(91)	$(1,610)	$(1,299)	$(2,394)
Net realized gain (loss) on sales of available-for-sale securities	$649	$(588)	$911	$(126)

Mortgage loans held-for-sale, net. Our mortgage loans held-for-sale, which are measured at fair value on a recurring basis, include (1) mortgage loans held-for-sale that are under commitments to sell and (2) mortgage loans held-for-sale that are not under commitments to sell. At September 30, 2016 and December 31, 2015, we had $90.5 million and $92.6 million, respectively, of mortgage loans held-for-sale under commitments to sell. The fair value for those loans was based on quoted market prices for those mortgage loans, which are Level 2 fair value inputs. At September 30, 2016 and December 31, 2015, we had $27.4 million and $23.1 million, respectively, of mortgage loans held-for-sale that were not under commitments to sell. The fair value for those loans was primarily based upon the estimated market price received from an outside party, which is a Level 2 fair value input.

Gains on sales of mortgage loans, net, are included as a component of revenues in the financial services section of our consolidated statements of operations and comprehensive income. For the three and nine months ended September 30, 2016, we recorded net gains on the sales of mortgage loans of $10.0 million and $22.5 million, respectively, compared to $3.4 million and $12.2 million for the same periods in the prior year, respectively.

Metropolitan district bond securities (related party). The metropolitan district bond securities (the “Metro Bonds”) are included in the homebuilding section of our consolidated balance sheets. We acquired the Metro Bonds from a quasi-municipal corporation in the state of Colorado (the “Metro District”), which was formed to help fund and maintain the infrastructure associated with a master-planned community being developed by our Company. Cash flows received by the Company from these securities reflect principal and interest payments from the Metro District, which are generally received in the fourth quarter, and are supported by an annual levy on the taxable assessed value of real estate and personal property within the Metro District’s boundaries. The stated year of maturity for the Metro Bonds is 2037. However, if the unpaid principal and all accrued interest are not paid off by the year 2037, the Company will continue to receive principal and interest payments in perpetuity until the unpaid principal and accrued interest is paid in full.

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In accordance with ASC Topic 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality* ("ASC 310-30"), we adjust the bond principal balance using an interest accretion model that utilizes future cash flows expected to be collected. Furthermore, as this investment is accounted for as an available-for-sale asset, we update its fair value on a quarterly basis, with the adjustment being recorded through AOCI. The fair value is based upon a discounted future cash flow model, which uses Level 3 inputs. The primary unobservable inputs used in our discounted cash flow model are (1) the forecasted number of homes to be closed, as they drive increases to the tax paying base for the Metro District, (2) the forecasted assessed value of those closed homes and (3) the discount rate. Cash receipts, which are scheduled to be received in the fourth quarter, reduce the carrying value of the Metro Bonds. The increases in the value of the Metro Bonds during the past two years are based on a larger percentage of future cash flows coming from homes that have closed, which utilize a lower discount rate as those cash flows have a reduced amount of risk. The table below provides quantitative data, as of September 30, 2016, regarding each unobservable input and the sensitivity of fair value to potential changes in those unobservable inputs.

	Quantitative Data				Sensitivity Analysis	
Unobservable Input	Range			Weighted Average	Movement in Fair Value from Increase in Input	Movement in Fair Value from Decrease in Input
Number of homes closed per year	0	to	127	102	Increase	Decrease
Average sales price	$400,000	to	$1.3 million	$527,000	Increase	Decrease
Discount rate	5%	to	12%	9.0%	Decrease	Increase

The table set forth below summarizes the activity for our Metro Bonds:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			
Balance at beginning of period	$28,604	$22,259	$25,911	$18,203
Increase in fair value (recorded in other comprehensive income)	117	1,472	1,982	4,815
Change due to accretion of principal	411	343	1,239	1,056
Cash receipts	-	-	-	-
Balance at end of period	$29,132	$24,074	$29,132	$24,074

Mortgage Repurchase Facility. The debt associated with our mortgage repurchase facility (see Note 18 for further discussion) is at floating rates that approximate current market rates and have relatively short-term maturities, generally within 30 days. The fair value approximates carrying value and is based on Level 2 inputs.

Senior Notes. The estimated values of the senior notes in the following table are based on Level 2 inputs, which primarily reflect estimated prices for our senior notes and were obtained from multiple pricing sources.

	September 30, 2016		December 31, 2015	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(Dollars in thousands)			
5 % Senior Notes due February 2020, net	$246,689	$268,688	$246,032	$257,813
5½% Senior Notes due January 2024	248,345	263,883	248,209	252,188
6% Senior Notes due January 2043	346,325	315,887	346,283	276,938
Total	$841,359	$848,458	$840,524	$786,939

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7. Inventories

The following table sets forth, by reportable segment, information relating to our homebuilding inventories:

	September 30, 2016	December 31, 2015
	(Dollars in thousands)	
Housing completed or under construction:		
West	$534,423	$365,867
Mountain	306,681	253,578
East	135,268	127,591
Total housing completed or under construction	976,372	747,036
Land and land under development:		
West	487,001	580,682
Mountain	252,838	259,484
East	130,894	176,760
Total land and land under development	870,733	1,016,926
Total inventories	$1,847,105	$1,763,962

Our inventories are primarily associated with communities where we intend to construct and sell homes, including models and unsold homes (defined as homes under construction without a sales contract). Costs capitalized to land and land under development primarily include: (1) land costs; (2) land development costs; (3) entitlement costs; (4) capitalized interest; (5) engineering fees; and (6) title insurance, real property taxes and closing costs directly related to the purchase of the land parcel. Components of housing completed or under construction primarily include: (1) land costs transferred from land and land under development; (2) direct construction costs associated with a house; (3) real property taxes, engineering fees, permits and other fees; (4) capitalized interest; and (5) indirect construction costs, which include field construction management salaries and benefits, utilities and other construction related costs. Land costs are transferred from land and land under development to housing completed or under construction at the point in time that construction of a home on an owned lot begins.

In accordance with ASC Topic 360, *Property, Plant, and Equipment* ("ASC 360"), homebuilding inventories, excluding those classified as held for sale, are carried at cost unless events and circumstances indicate that the carrying value of the underlying subdivision may not be recoverable. We evaluate inventories for impairment at each quarter end on a subdivision level basis as each such subdivision represents the lowest level of identifiable cash flows. In making this determination, we review, among other things, the following for each subdivision:

- actual and trending "Operating Margin" (which is defined as home sale revenues less home cost of sales and all direct incremental costs associated with the home closing, including sales commissions) for homes closed;
- estimated future undiscounted cash flows and Operating Margin;
- forecasted Operating Margin for homes in backlog;
- actual and trending net and gross home orders;
- base sales price and home sales incentive information for homes closed, homes in backlog and homes available for sale;
- market information for each sub-market, including competition levels, home foreclosure levels, the size and style of homes currently being offered for sale and lot size; and
- known or probable events indicating that the carrying value may not be recoverable.

If events or circumstances indicate that the carrying value of our inventory may not be recoverable, assets are reviewed for impairment by comparing the undiscounted estimated future cash flows from an individual subdivision (including capitalized interest) to its carrying value. If the undiscounted future cash flows are less than the subdivision's carrying value, the carrying value of the subdivision is written down to its then estimated fair value. We generally determine the estimated fair value of each subdivision by determining the present value of the estimated future cash flows at discount rates, which are Level 3 inputs, that are commensurate with the risk of the subdivision under evaluation. The evaluation for the recoverability of the carrying value of the assets for each individual subdivision can be impacted significantly by our estimates of future home sale revenues, home construction costs, and development costs per home, all of which are Level 3 inputs.

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If land is classified as held for sale, in accordance with ASC 360, we measure it at the lower of the carrying value or fair value less estimated costs to sell. In determining fair value, we primarily rely upon the most recent negotiated price which is a Level 2 input. If a negotiated price is not available, we will consider several factors including, but not limited to, current market conditions, recent comparable sales transactions and market analysis studies. If the fair value less estimated costs to sell is lower than the current carrying value, the land is impaired down to its estimated fair value less costs to sell.

Impairments of homebuilding inventory by segment for the three and nine months ended September 30, 2016 and 2015 are shown in the table below. In addition to the impairments shown below, using Level 2 inputs, we recorded $1.1 million of impairments on our land held for sale during the three and nine months ended September 30, 2015. No such impairments were recorded during the same periods in 2016.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			
West	$-	$-	$1,400	$-
Mountain	-	250	-	250
East	4,700	2,975	4,900	3,325
Total inventory impairments	$4,700	$3,225	$6,300	$3,575

The table below provides quantitative data, for the periods presented, used in determining the fair value of the impaired inventory.

	Impairment Data				Quantitative Data
Three Months Ended	Total Subdivisions Tested	Inventory Impairments	Fair Value of Inventory After Impairments	Number of Subdivisions Impaired	Discount Rate
	(Dollars in thousands)				
March 31, 2016	14	$ -	$ -	-	N/A
June 30, 2016	17	$ 1,600	$ 6,415	2	12% to 15%
September 30, 2016	25	$ 4,700	$ 12,295	2	15% to 18%

March 31, 2015	22	$	350	$	3,701	1		8.7%	
June 30, 2015	22	$	-	$	-	-		N/A	
September 30, 2015	18	$	3,225	$	14,836	5	12%	to	15%

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8. Capitalization of Interest

We capitalize interest to inventories during the period of development in accordance with ASC Topic 835, Interest ("ASC 835"). Homebuilding interest capitalized as a cost of inventories is included in cost of sales during the period that related units or lots are delivered. To the extent our homebuilding debt exceeds our qualified assets as defined in ASC 835, we expense a portion of the interest incurred. For all periods presented, our qualified assets exceeded our homebuilding debt and as such, all interest incurred has been capitalized. Qualified homebuilding assets consist of all lots and homes, excluding finished unsold homes or finished models, within projects that are actively selling or under development. The table set forth below summarizes homebuilding interest activity.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			
Homebuilding interest incurred	$13,187	$13,265	$39,511	$39,821
Less: Interest capitalized	(13,187)	(13,265)	(39,511)	(39,821)
Homebuilding interest expensed	$-	$-	$-	$-
Interest capitalized, beginning of period	$77,150	$78,857	$77,541	$79,231
Plus: Interest capitalized during period	13,187	13,265	39,511	39,821
Less: Previously capitalized interest included in home and land cost of sales	(15,922)	(12,878)	(42,637)	(39,808)
Interest capitalized, end of period	$74,415	$79,244	$74,415	$79,244

9. Homebuilding Prepaid and Other Assets

The following table sets forth the components of homebuilding prepaid and other assets:

	September 30, 2016	December 31, 2015

	(Dollars in thousands)	
Land option deposits	$7,360	$ 11,997
Deferred marketing costs	35,335	31,152
Prepaid expenses	7,539	6,500
Goodwill	6,008	6,008
Deferred debt issuance costs, net	4,721	5,570
Other	5,232	4,167
Total	$66,195	$ 65,394

10. Homebuilding Accrued Liabilities and Financial Services Accounts Payable and Accrued Liabilities

The following table sets forth information relating to homebuilding accrued liabilities:

	September 30, 2016	December 31, 2015
	(Dollars in thousands)	
Customer and escrow deposits	$30,875	$20,717
Warranty accrual	18,709	15,328
Accrued compensation and related expenses	24,723	25,492
Accrued interest	11,031	23,234
Land development and home construction accruals	7,705	11,465
Other accrued liabilities	29,184	26,650
Total accrued liabilities	$122,227	$122,886

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The following table sets forth information relating to financial services accounts payable and accrued liabilities:

	September 30, 2016	December 31, 2015
	(Dollars in thousands)	
Insurance reserves	$48,153	$ 45,811
Accounts payable and other accrued liabilities	8,781	6,303
Total accounts payable and accrued liabilities	$56,934	$ 52,114

11. Warranty Accrual

Our homes are sold with limited third-party warranties. We record accruals for general and structural warranty claims, as well as accruals for known, unusual warranty-related expenditures. Our warranty accruals are recorded based upon historical payment experience in an amount estimated to be adequate to cover expected costs of materials and outside labor during warranty periods. The determination of the warranty accrual rate for closed homes and the evaluation of our warranty accrual balance at period end are based on an internally developed analysis that includes known facts and interpretations of circumstances, including, among other things, our trends in historical warranty payment levels and warranty payments for claims not considered to be normal and recurring.

Our warranty accrual is included in accrued liabilities in the homebuilding section of our consolidated balance sheets and adjustments to our warranty accrual are recorded as an increase or reduction to home cost of sales in the homebuilding section of our consolidated statements of operations and comprehensive income.

The table set forth below summarizes accrual, adjustment and payment activity related to our warranty accrual for the three and nine months ended September 30, 2016 and 2015. For the three and nine months ended September 30, 2016 we recorded adjustments of $1.8 million and $5.1 million, respectively, to increase our warranty accrual primarily due to higher than expected recent warranty related expenditures. For the nine months ended September 30, 2015, we reduced our warranty reserve by $0.2 million, while for the three months ended September 30, 2015 there was no adjustment.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			
Balance at beginning of period	$17,217	$17,253	$15,328	$18,346
Expense provisions	2,390	1,536	6,147	3,980
Cash payments	(2,723)	(2,708)	(7,828)	(6,032)
Adjustments	1,825	-	5,062	(213)
Balance at end of period	$18,709	$16,081	$18,709	$16,081

12. Insurance Reserves

The establishment of reserves for estimated losses associated with (1) insurance policies issued by Allegiant, (2) re-insurance agreements issued by StarAmerican, and (3) self-insured retentions for our homebuilding subsidiaries are based on actuarial studies that include known facts and interpretations of circumstances, including our experience with similar cases and historical trends involving claim payment patterns, pending levels of unpaid claims, product mix or concentration, claim severity, frequency patterns depending on the business conducted, and changing regulatory and legal environments. It is possible that future changes in the insurance payment experience used in estimating our ultimate insurance losses could have a material impact on our insurance reserves.

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The table set forth below summarizes the insurance reserve activity for the three and nine months ended September 30, 2016 and 2015. The insurance reserve is included as a component of accrued liabilities in the financial services section of the consolidated balance sheets.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			
Balance at beginning of period	$46,900	$47,389	$45,811	$50,470
Expense provisions	1,888	1,652	5,222	4,501
Cash payments, net of recoveries	(635)	(2,356)	(2,880)	(6,786)
Adjustments	-	-	-	(1,500)
Balance at end of period	$48,153	$46,685	$48,153	$46,685

The adjustment to decrease our insurance reserve during the nine months ended September 30, 2015 primarily resulted from a decrease in insurance claim payment severity and frequency relative to prior period estimates.

In the ordinary course of business, we make payments from our insurance reserves to settle litigation claims arising primarily from our homebuilding activities. These payments are irregular in both their timing and their magnitude. As a result, the cash payments, net of recoveries shown for the three and nine months ended September 30, 2016 and 2015 are not necessarily indicative of what future cash payments will be for subsequent periods.

13. Income Taxes

At the end of each interim period, we are required to estimate our annual effective tax rate for the fiscal year and use that rate to provide for income taxes for the current year-to-date reporting period. Our overall effective income tax rates were 30.7% and 32.3% for the three and nine months ended September 30, 2016, respectively, compared to 37.5% and 37.3% for the three and nine months ended September 30, 2015, respectively. The rates for the three and nine months ended September 30, 2016 resulted in income tax expense of $11.7 million and $29.9 million, respectively, compared to income tax expense of $8.9 million and $25.7 million for the three and nine months ended September 30, 2015. The year-over-year improvements in our effective tax rates are primarily the result of our estimated 2016 full year effective tax rate including (1) an estimate for energy credits versus no such estimate as of September 30, 2015 as the credit for both 2015 and 2016 was not approved by the U.S. Congress until December of 2015 and (2) a domestic manufacturing deduction whereas we were not eligible for this deduction in the prior year due to our net operating loss carryforwards.

At September 30, 2016 and December 31, 2015 we had deferred tax assets, net of valuation allowances and deferred tax liabilities, of $85.1 million and $99.1 million, respectively. The valuation allowances were related to: (1) various state net operating loss carryforwards where realization is more uncertain at this time due to the limited carryforward periods that exist in certain states; and (2) the portion of the amount by which the carrying value of our Metro Bonds for tax purposes exceeds our carrying value for book purposes, as we believe realization of that portion is more uncertain at this time.

14. Senior Notes

The carrying value of our senior notes as of September 30, 2016 and December 31, 2015, net of any unamortized debt issuance costs or discount, were as follows:

	September 30, 2016	December 31, 2015
	(Dollars in thousands)	
5 % Senior notes due February 2020, net	$246,689	$246,032
5½% Senior notes due January 2024	248,345	248,209
6% Senior notes due January 2043	346,325	346,283
Total senior notes	$841,359	$840,524

Our senior notes are not secured and, while the senior note indentures contain some restrictions on secured debt and other transactions, they do not contain financial covenants. Our senior notes are fully and unconditionally guaranteed on an unsecured basis, jointly and severally, by substantially all of our homebuilding segment subsidiaries.

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15. Stock Based Compensation

We account for share-based awards in accordance with ASC 718, which requires the fair value of stock-based compensation awards to be amortized as an expense over the vesting period. Stock-based compensation awards are valued at fair value on the date of grant. The following table sets forth share-based award expense activity for the three and nine months ended September 30, 2016 and 2015:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			
Stock option grant expense	$328	$3,544	$5,621	$5,043
Restricted stock awards expense	145	454	1,015	1,546
Total stock based compensation	$473	$3,998	$6,636	$6,589

On May 18, 2015, the Company granted a non-qualified stock option to each of the Chief Executive Officer and the Chief Operating Officer for 1,000,000 shares of common stock under the Company's 2011 Equity Incentive Plan. The terms of each option provide that, over a five year period, one third of the option shares will vest as of each of the third, fourth, and fifth anniversary dates of the grant of the option; provided that all unvested option shares will vest immediately in the event the closing price of the Company's stock, as reported by the New York Stock Exchange, in any 20 out of 30 consecutive trading days closes at a price equal to or greater than 120% of the closing price on the date of grant (the "market-based condition"). The option exercise price is equal to the closing price of the Company's common stock on the date of grant, which was $28.45 and the expiration date of each option is May 18, 2025. In accordance with ASC 718, the market-based awards were assigned a fair value of $5.62 per share (total value of $11.2 million) on the date of grant using a Monte Carlo simulation model and, as calculated under that model, all expense was recorded on a straight-line basis through the end of the 2016 second quarter. Included in the stock based compensation expense for the three and nine months ended September 30, 2016, shown in the table above, was $0 and $5.0 million, respectively, of stock option grant expense related to these market-based option grants. For the three and nine months ended September 30, 2015, $2.5 million and $3.7 million, respectively, of stock option grant expense was related to these market-based option grants.

On July 25, 2016, the Company granted long term performance stock unit awards ("PSUs") to each of the Chief Executive Officer, the Chief Operating Officer, and the Chief Financial Officer under the Company's 2011 Equity

Incentive Plan. The PSUs will be earned based upon the Company's performance, over a three year period commencing July 1, 2016 and ending June 30, 2019 (the "Performance Period"), measured by increasing home sale revenues over the Base Period. The "Base Period" for the awards is July 1, 2015 to June 30, 2016. The awards are conditioned upon the Company achieving an average gross margin from home sales percentage (excluding impairments) of at least fifteen percent (15%) over the Performance Period. Target goals of 100,000 shares for each of the Chief Executive Officer and the Chief Operating Officer and 25,000 shares for the Chief Financial Officer (the "Target Goals") will be earned if the Company's three year average home sale revenues over the Performance Period ("Performance Revenues") exceed the home sale revenues over the Base Period ("Base Revenues") by at least 10% but less than 20%. If Performance Revenues exceed the Base Revenues by at least 5% but less than 10%, 50% of the Target Goals will be earned. If Performance Revenues exceed the Base Revenues by at least 20%, 200% of the Target Goals will be earned.

In accordance with ASC 718, the PSUs are valued at the fair value on the date of grant. The grant date fair value of these awards was $24.08 per share and the maximum potential expense that would be recognized by the Company if the maximum of the performance targets were met would be approximately $10.8 million. ASC 718 prohibits recognition of expense associated with performance based stock awards until achievement of the performance targets are probable of occurring. As of September 30, 2016, the Company concluded that achievement of the performance targets had not met the level of probability required to record compensation expense at that time and, as such, no compensation expense was recognized related to the grant of these awards during the 2016 third quarter.

16. Commitments and Contingencies

Surety Bonds and Letters of Credit. We are required to obtain surety bonds and letters of credit in support of our obligations for land development and subdivision improvements, homeowner association dues, warranty work, contractor license fees and earnest money deposits. At September 30, 2016, we had outstanding surety bonds and letters of credit totaling $179.3 million and $58.9 million, respectively, including $32.6 million in letters of credit issued by HomeAmerican. The estimated cost to complete obligations related to these bonds and letters of credit were approximately $53.8 million and $31.9 million, respectively. All letters of credit as of September 30, 2016, excluding those issued by HomeAmerican, were issued under our unsecured revolving credit facility (see Note 18 for further discussion of the revolving credit facility). We expect that the obligations secured by these performance bonds and letters of credit generally will be performed in the ordinary course of business and in accordance with the applicable contractual terms. To the extent that the obligations are performed, the related performance bonds and letters of credit should be released and we should not have any continuing obligations. However, in the event any such performance bonds or letters of credit are called, our indemnity obligations could require us to reimburse the issuer of the performance bond or letter of credit.

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We have made no material guarantees with respect to third-party obligations.

Mortgage Loan Loss Reserves. In the normal course of business, we establish reserves for potential losses associated with HomeAmerican's sale of mortgage loans to third-parties. These reserves are created to address repurchase and indemnity claims by third-party purchasers of the mortgage loans, which claims arise primarily out of, but are not limited to, allegations of homebuyer fraud at the time of origination of the loan, missing documentation, loan processing defects or defective appraisals. These reserves are based upon, among other things: (1) pending claims received from third-party purchasers associated with previously sold mortgage loans; (2) a current assessment of the potential exposure associated with future claims of loan processing defects or homebuyer fraud in mortgage loans originated in prior periods; and (3) historical loss experience. In addition to reserves established for mortgage loans previously sold to third-parties, we establish reserves for loans that we have been required to repurchase. Our mortgage loan reserves are reflected as a component of accrued liabilities in the financial services section of the consolidated balance sheets, and the associated expenses are included in expenses in the financial services section of the consolidated statements of operations and comprehensive income.

The following table summarizes the mortgage loan loss reserve activity for the three and nine months ended September 30, 2016 and 2015:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(Dollars in thousands)			
Balance at beginning of period	$160	$1,058	$201	$810
Expense provisions	6	39	6	764
Cash payments	-	(325)	-	(325)
Adjustments	-	(568)	(41)	(1,045)
Balance at end of period	$166	$204	$166	$204

Legal Reserves. Because of the nature of the homebuilding business, we have been named as defendants in various claims, complaints and other legal actions arising in the ordinary course of business, including product liability claims and claims associated with the sale and financing of homes. In the opinion of management, the outcome of these ordinary course matters will not have a material adverse effect upon our financial condition, results of operations or cash flows.

Lot Option Contracts. In the normal course of business, we enter into lot option purchase contracts (“Option Contracts”), generally through a deposit of cash or a letter of credit, for the right to purchase land or lots at a future point in time with predetermined terms. The use of such land option and other contracts generally allow us to reduce the risks associated with direct land ownership and development, reduces our capital and financial commitments, and minimizes the amount of land inventories on our consolidated balance sheets. Our obligation with respect to Option Contracts is generally limited to forfeiture of the related deposits. At September 30, 2016, we had cash deposits and letters of credit totaling $6.9 million and $2.4 million, respectively, at risk associated with the option to purchase 2,504 lots.

17. Derivative Financial Instruments

The derivative instruments we utilize in the normal course of business are interest rate lock commitments and forward sales of mortgage-backed securities, both of which typically are short-term in nature. Forward sales of mortgage-backed securities are utilized to hedge changes in fair value of our interest rate lock commitments as well as mortgage loans held-for-sale not under commitments to sell. For forward sales of mortgage-backed securities, as well as interest rate lock commitments that are still outstanding at the end of a reporting period, we record the changes in fair value of the derivatives in revenues in the financial services section of our consolidated statements of operations and comprehensive income with an offset to other assets or accounts payable and accrued liabilities in the financial services section of our consolidated balance sheets, depending on the nature of the change.

At September 30, 2016, we had interest rate lock commitments with an aggregate principal balance of $105.8 million. Additionally, we had $26.8 million of mortgage loans held-for-sale at September 30, 2016 that had not yet been committed to a mortgage purchaser. In order to hedge the changes in fair value of our interest rate lock commitments and mortgage loans held-for-sale that had not yet been committed to a mortgage purchaser, we had forward sales of securities totaling $88.5 million at September 30, 2016.

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For the three and nine months ended September 30, 2016, we recorded net gains on our derivatives of $0.1 million and $1.1 million, respectively, compared to $0.9 and $1.5 million for the same periods in 2015.

18. Lines of Credit

Revolving Credit Facility. We have an unsecured revolving credit agreement ("Revolving Credit Facility") with a group of lenders, which may be used for general corporate purposes. This agreement has an aggregate commitment of $550 million (the "Commitment") and was amended on December 18, 2015 to extend the maturity to December 18, 2020. Each lender may issue letters of credit in an amount up to 50% of its commitment. The facility permits an increase in the maximum Commitment amount to $1.0 billion upon our request, subject to receipt of additional commitments from existing or additional lenders and the consent of the designated agent and the co-administrative agent. As defined in the Revolving Credit Facility agreement, interest rates on outstanding borrowings are equal to the highest of: (1) 0.0% or (2) a specified eurocurrency rate, federal funds effective rate or prime rate, plus a margin that is determined based on our credit ratings and leverage ratio. At any time at which our leverage ratio, as of the last day of the most recent calendar quarter, exceeds 55%, the aggregate principal amount of all consolidated senior debt borrowings outstanding may not exceed the borrowing base. There is no borrowing base requirement if our leverage ratio, as of the last day of the most recent calendar quarter, is 55% or less.

The Revolving Credit Facility is fully and unconditionally guaranteed, jointly and severally, by most of our homebuilding segment subsidiaries. The facility contains various representations, warranties and covenants that we believe are customary for agreements of this type. The financial covenants include a consolidated tangible net worth test and a leverage test, along with a consolidated tangible net worth covenant, all as defined in the facility agreement. A failure to satisfy the foregoing tests does not constitute an event of default, but can trigger a "term-out" of the facility. A breach of the consolidated tangible net worth covenant (but not the consolidated tangible net worth test) or a violation of anti-corruption or sanctions laws would result in an event of default.

The Revolving Credit Facility is subject to acceleration upon certain specified events of default, including breach of the consolidated tangible net worth covenant, a violation of anti-corruption or sanctions laws, failure to make timely payments, breaches of certain representations or covenants, failure to pay other material indebtedness, or another person becoming beneficial owner of 50% or more of our outstanding common stock. We believe we were in compliance with the representations, warranties and covenants included in the Revolving Credit Facility as of September 30, 2016.

We incur costs associated with unused commitment fees pursuant to the terms of the Revolving Credit Facility. At September 30, 2016 and December 31, 2015, there were $26.2 million and $22.5 million, respectively, in letters of credit outstanding, which reduced the amounts available to be borrowed under the Revolving Credit Facility. At both September 30, 2016 and December 31, 2015, we had $15.0 million in outstanding borrowings under the Revolving Credit Facility. As of September 30, 2016, availability under the Revolving Credit Facility was approximately $508.8 million.

Mortgage Repurchase Facility. HomeAmerican entered into an Amended and Restated Master Repurchase Agreement (the “Mortgage Repurchase Facility”) with U.S. Bank National Association (“USBNA”), effective September 16, 2016. The Mortgage Repurchase Facility amends and restates the prior Master Repurchase Agreement with USBNA dated as of November 12, 2008, as amended, which contained similar terms. The Mortgage Repurchase Facility increases the facility amount from $50 million to $75 million, extends the expiration date to September 15, 2017, adjusts the facility’s sublimits, expands the types of eligible loans, and reduces the facility fee. The Mortgage Repurchase Facility provides liquidity to HomeAmerican by providing for the sale of eligible mortgage loans to USBNA with an agreement by HomeAmerican to repurchase the mortgage loans at a future date. Until such mortgage loans are transferred back to HomeAmerican, the documents relating to such loans are held by USBNA, as custodian, pursuant to the Custody Agreement (“Custody Agreement”), dated as of November 12, 2008, by and between HomeAmerican and USBNA. In the event that an eligible mortgage loan becomes ineligible, as defined under the Mortgage Repurchase Facility, HomeAmerican may be required to repurchase the ineligible mortgage loan immediately. The maximum aggregate commitment of the Mortgage Repurchase Facility was temporarily increased on September 27, 2016 from $75 million to $110 million and was effective through October 26, 2016. The Mortgage Repurchase Facility also had a temporary increase in the maximum aggregate commitment from $50 million to $90 million from December 23, 2015 through January 31, 2016. At September 30, 2016 and December 31, 2015, there were $92.0 million and $88.6 million, respectively, of mortgage loans that HomeAmerican was obligated to repurchase under the Mortgage Repurchase Facility. Mortgage loans that HomeAmerican is obligated to repurchase under the Mortgage Repurchase Facility are accounted for as a debt financing arrangement and are reported as mortgage repurchase facility in the consolidated balance sheets. Advances under the Mortgage Repurchase Facility carry a price range that is LIBOR-based. The Mortgage Repurchase Facility contains various representations, warranties and affirmative and negative covenants that we believe are customary for agreements of this type. The negative covenants include, among others, (i) a minimum Adjusted Tangible Net Worth requirement, (ii) a maximum Adjusted Tangible Net Worth ratio, (iii) a minimum adjusted net income requirement, and (iv) a minimum Liquidity requirement. The foregoing capitalized terms are defined in the Mortgage Repurchase Facility. We believe HomeAmerican was in compliance with the representations, warranties and covenants included in the Mortgage Repurchase Facility as of September 30, 2016.

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19. Supplemental Guarantor Information

Our senior notes are fully and unconditionally guaranteed on an unsecured basis, jointly and severally, by the following subsidiaries (collectively, the "Guarantor Subsidiaries"), which are 100%-owned subsidiaries of the Company.

M.D.C. Land Corporation
RAH of Florida, Inc.