Meritage Homes CORP
Form 10-Q
November 01, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended September 30, 2013

Or

o 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)	(I.R.S. Employer Identification No.)
17851 North 85th Street, Suite 300 Scottsdale, Arizona	85255
(Address of Principal Executive Offices)	(Zip Code)

(480) 515-8100
(Registrant's Telephone Number, Including Area Code)
(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

Indicate by a checkmark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Date 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 x No o

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

Large accelerated filer	x	Accelerated filer	o
Non-accelerated filer	o (Do not check if a smaller reporting company)	Smaller reporting company	o

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

Common shares outstanding as of October 31, 2013: 36,241,671

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FORM 10-Q FOR THE QUARTER ENDED SEPTEMBER 30, 2013
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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)

	September 30, 2013	December 31, 2012
Assets:		
Cash and cash equivalents	$177,584	$170,457
Investments and securities	92,846	86,074
Restricted cash	40,904	38,938
Other receivables	35,711	20,290
Real estate	1,345,214	1,113,187
Real estate not owned	481	—
Deposits on real estate under option or contract	34,911	14,351
Investments in unconsolidated entities	10,662	12,085
Property and equipment, net	18,690	15,718
Deferred tax asset	80,390	77,974
Prepaids, other assets and goodwill	36,693	26,488
Total assets	$1,874,086	$1,575,562
Liabilities:		
Accounts payable	$76,647	$49,801
Accrued liabilities	178,247	96,377
Home sale deposits	28,183	12,377
Liabilities related to real estate not owned	346	—
Senior, senior subordinated, convertible senior notes and other borrowings	798,337	722,797
Total liabilities	1,081,760	881,352
Stockholders' Equity:		
Preferred stock, par value $0.01. Authorized 10,000,000 shares; none issued and outstanding at September 30, 2013 and December 31, 2012	—	—
Common stock, par value $0.01. Authorized 125,000,000 shares; issued 36,231,201 and 35,613,351 shares at September 30, 2013 and December 31, 2012, respectively	362	356
Additional paid-in capital	409,984	390,249
Retained earnings	381,980	303,605
Total stockholders' equity	792,326	694,210
Total liabilities and stockholders' equity	$1,874,086	$1,575,562

See accompanying notes to unaudited consolidated financial statements

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Homebuilding:				
Home closing revenue	$483,147	$334,880	$1,249,897	$820,242
Land closing revenue	8,933	7,763	28,568	8,846
Total closing revenue	492,080	342,643	1,278,465	829,088
Cost of home closings	(372,772)	(272,726)	(981,557)	(671,029)
Cost of land closings	(6,126)	(7,493)	(24,139)	(8,833)
Total cost of closings	(378,898)	(280,219)	(1,005,696)	(679,862)
Home closing gross profit	110,375	62,154	268,340	149,213
Land closing gross profit	2,807	270	4,429	13
Total closing gross profit	113,182	62,424	272,769	149,226
Financial Services:				
Revenue	1,684	253	3,960	253
Expense	(901)	(317)	(2,229)	(484)
Earnings from financial services unconsolidated entities and other, net	3,511	3,049	9,784	6,974
Financial services profit	4,294	2,985	11,515	6,743
Commissions and other sales costs	(33,467)	(25,855)	(90,526)	(67,950)
General and administrative expenses	(24,412)	(19,209)	(66,587)	(50,446)
Earnings/(loss) from other unconsolidated entities, net	46	(74)	(229)	(348)
Interest expense	(3,462)	(5,009)	(13,113)	(18,718)
Other income, net	605	(8,276)	1,760	(7,481)
Loss on early extinguishment of debt	—	—	(3,796)	(5,772)
Earnings before income taxes	56,786	6,986	111,793	5,254
(Provision for)/benefit from income taxes	(18,595)	(202)	(33,418)	4,781
Net earnings	$38,191	$6,784	$78,375	$10,035
Earnings per common share:				
Basic	$1.05	$0.19	$2.17	$0.30
Diluted	$0.99	$0.19	$2.05	$0.30
Weighted average number of shares:				
Basic	36,226	35,216	36,060	33,541
Diluted	38,865	35,761	38,771	34,010

See accompanying notes to unaudited consolidated financial statements

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

	Nine Months Ended September 30	
	2013	2012
Cash flows from operating activities:		
Net earnings	$78,375	$10,035
Adjustments to reconcile net earnings to net cash used in operating activities:		
Depreciation and amortization	7,169	5,913
Stock-based compensation	7,040	6,095
Loss on early extinguishment of debt	3,796	5,772
Equity in earnings from unconsolidated entities	(9,555)	(6,626)
Deferred tax asset valuation benefit	(4,614)	(7,709)
Distributions of earnings from unconsolidated entities	10,796	6,118
Other	1,338	1,976
Changes in assets and liabilities:		
Increase in real estate	(221,668)	(190,509)
(Increase)/decrease in deposits on real estate under option or contract	(20,425)	2,192
Increase in receivables and prepaid expenses and other assets	(14,224)	(1,882)
Increase in accounts payable and accrued liabilities	106,862	31,204
Increase in home sale deposits	15,584	5,169
Net cash used in operating activities	(39,526)	(132,252)
Cash flows from investing activities:		
Purchases of property and equipment	(9,717)	(7,139)
Maturities of investments and securities	132,900	190,701
Payments to purchase investments and securities	(139,672)	(109,798)
Cash paid for acquisitions	(18,379)	—
Other	(1,955)	(3,020)
Net cash (used in)/provided by investing activities	(36,823)	70,744
Cash flows from financing activities:		
Repayment of senior subordinated notes	(102,822)	(315,080)
Proceeds from issuance of senior notes	175,000	426,500
Proceeds from issuance of common stock, net	—	87,125
Other	11,298	(5,600)
Net cash provided by financing activities	83,476	192,945
Net increase in cash and cash equivalents	7,127	131,437
Cash and cash equivalents at beginning of period	170,457	173,612
Cash and cash equivalents at end of period	$177,584	$305,049

See supplemental disclosures of cash flow information at Note 11.
See accompanying notes to unaudited consolidated financial statements

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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 detached homes. We primarily build in the historically high-growth regions of the western and southern United States and offer a variety of homes that are designed to appeal to a wide range of homebuyers, including first-time, move-up, active adult and luxury. We have homebuilding operations in three regions: West, Central and East, which are comprised of seven states: Arizona, Texas, California, Colorado, Florida, the Carolinas and Tennessee. Operations within the Carolinas include the Raleigh and Charlotte metropolitan areas, with some Charlotte communities located across the border into South Carolina. In August 2013, we entered the Nashville, Tennessee market through the acquisition of the assets and operations of Phillips Builders LLC and selected assets of Phillips Development LLC ("Phillips Builders"). With this acquisition, we acquired approximately 500 lots, contributing 30 units in backlog as of September 30, 2013. Through our predecessors, we commenced our homebuilding operations in 1985. In 2012, we commenced limited operations of our wholly-owned title company, Carefree Title Agency, Inc. ("Carefree Title"). Carefree Title's core business consists of title insurance and closing/settlement services we offer to our homebuyers and we expect to be fully operational in applicable markets by the end of 2013. 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 other than in Tennessee, where we operate under the Phillips Builders brand name. We also operate as Monterey Homes in some markets in Arizona and Texas. At September 30, 2013, we were actively selling homes in 179 communities, with base prices ranging from approximately $130,000 to $994,000.

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, 2012. 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 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. Certain reclassifications have been made to the prior year income statements and footnotes to conform to the current year presentation.

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 for home closings of approximately $43.2 million and $30.4 million are included in cash and cash equivalents at September 30, 2013 and December 31, 2012, respectively. Included in our cash and cash equivalents balance as of September 30, 2013 and December 31, 2012 are $20.3 million and $0.3 million, respectively, of money market funds that are invested in short term (three months or less) U.S. government securities.

Restricted Cash. Restricted cash consists of amounts held in restricted accounts as collateral for our letter of credit arrangements. The aggregate capacity of these secured letter of credit arrangements was $60.0 million at September 30, 2013. Our restricted cash accounts invest in money market accounts and U.S. government securities and totaled $40.9 million and $38.9 million at September 30, 2013 and December 31, 2012, respectively.

Investments and Securities. Our investments and securities are comprised of both treasury securities and deposits with banks that are FDIC-insured and secured by U.S. government treasury-backed investments, and therefore we believe bear a limited risk of loss. All of our investments are classified as held-to-maturity and are recorded at amortized cost as we have both the ability and intent to hold them until their respective maturities. The contractual lives of these

investments are greater than three months but do not exceed 18 months. Due to their short duration and low contractual interest rates, the amortized cost of the investments approximates fair value with no unrecognized gains and losses or other-than-temporary impairments.

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”) Subtopic 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 most selling 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. Therefore, we record an accrued liability to capture such obligations in connection with the home closing and charged directly to cost of sales.

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 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. Our analysis is completed on a quarterly basis with each community or land parcel evaluated individually. For those assets deemed to be impaired, the impairment recognized is measured as the amount by which the assets’ carrying amount exceeds their fair value. The impairment of a community is allocated to each lot on a straight-line basis.

Existing and continuing communities. When projections for the remaining income expected to be earned from existing communities are no longer positive, the underlying real estate assets are not deemed fully recoverable, and further analysis is performed to determine the required impairment. The fair value of the community’s assets is determined using either a discounted cash flow model for projects we intend to build out or a market-based approach for projects to be sold. Impairments are charged to cost of home closings in the period during which it is determined that the fair value is less than the assets’ carrying amount. If a market-based approach is used, we determine fair value based on recent comparable purchase and sale activity in the local market, adjusted for variances as determined by our knowledge of the region and general real estate expertise. If a discounted cash flow approach is used, we compute fair value based on a proprietary model. Our key estimates in deriving fair value under our cash flow model are (i) home selling prices in the community adjusted for current and expected sales discounts and incentives, (ii) costs related to the community — both land development and home construction — including costs spent to date and budgeted remaining costs to spend, (iii) projected sales absorption rates, reflecting any product mix change strategies and expected cancellation rates, (iv) alternative land uses including disposition of all or a portion of the land owned and (v) our discount rate, which is currently 14-16% and varies based on the perceived risk inherent in the community’s other cash flow assumptions. These assumptions vary widely across different communities and geographies and are largely dependent on local market conditions. Community-level factors that may impact our key estimates include:

- The presence and significance of local competitors, including their offered product type and pricing, comparable lot size, and competitive actions;
- Economic and related demographic conditions for the population of the surrounding community;

- Desirability of the particular community, including unique amenities or other favorable or unfavorable attributes; and
- Existing home inventory supplies, including foreclosures and short sales.

These local circumstances may significantly impact our assumptions and the resulting computation of fair value and are, therefore, closely evaluated by our division personnel in their generation of the discounted cash flow models. The models are also evaluated by regional and corporate personnel for consistency and integration, as decisions that affect pricing or absorption at one community may have resulting consequences for neighboring or nearby communities. We typically do not

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project market improvements in our discounted cash flow models, but may do so in limited circumstances in the latter years of a long-lived community.

Mothball communities. In certain cases, we may elect to stop development of an existing community (mothball) if we believe the economic performance of the community would be maximized by deferring development for a period of time to allow market conditions to improve. When a community is initially placed into mothball status, it is management's belief that the community is affected by local market conditions that are expected to improve within the next 1-5 years. Therefore, a temporary postponement of construction and development work is expected to yield better overall future returns. The decision may be based on financial and/or operational metrics. If we decide to mothball a community, we will, if necessary, impair it to its fair value as discussed above and then cease future development activity until such time as management believes that market conditions have improved and economic performance will be maximized. No costs are capitalized related to communities that are designated as mothballed.

In addition to our quarterly impairment analysis, which is conducted to determine if any current impairments exist, we also conduct a thorough quarterly review of our underperforming and mothballed communities to determine if they are at risk of future impairment. The financial and operational status and expectations of these communities are analyzed as well as any unique attributes that could be viewed as indicators for future impairments. Adjustments are made accordingly and incremental impairments, if any, are recorded at each re-evaluation. Based on the facts and circumstances available as of September 30, 2013, we do not believe that any of our underperforming or mothballed communities will incur material impairments in the future. Changes in market and/or economic conditions could materially impact the conclusions of this analysis, and there can be no assurances that future impairments will not occur.

Inventory assessments on inactive assets. For our mothballed communities as well as our land held for future development, our inventory assessments typically include highly subjective estimates for future performance, including the timing of development, the product to be offered, sales rates and selling prices of the product when the community is anticipated to open for sales, and the projected costs to develop and construct the community. We evaluate various factors to develop our forecasts, including the availability of and demand for homes and finished lots within the marketplace, historical, current and future sales trends, and third-party data, if available. Based on these factors, we reach conclusions for future performance based on our judgment.

Deposits. Deposits paid related to purchase contracts and land options are recorded and classified as Deposits on real estate under contract or option until the related land is purchased. Deposits are reclassified as a component of real estate inventory at the time the deposit is used to offset the acquisition price of the lots based on the terms of the underlying agreements. To the extent they are non-refundable, deposits are charged to expense if the land acquisition is terminated or no longer considered probable. Since the 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. The review of the likelihood of the acquisition of contracted lots is completed quarterly in conjunction with the real estate impairment analysis noted above and therefore, if impaired, the deposits are recorded at the lower of cost or fair value. Our deposits were $34.9 million and $14.4 million as of September 30, 2013 and December 31, 2012, respectively.

Off-Balance Sheet Arrangements —Joint Ventures. In the past, we have participated in 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; however, in recent years, such ventures have not been a significant avenue for us to access lots. See Note 4 for additional discussion of our investments in unconsolidated entities.

Off-Balance Sheet Arrangements — Other. We may acquire lots from various development and land bank entities pursuant to purchase and option agreements. The purchase price generally approximates the market price at the date the contract is executed (with possible future escalators). See Note 3 for further discussion.

We may provide letters of credit in support of our obligations relating to the development of our projects and other corporate purposes. We may also utilize surety bonds to guarantee our performance of certain development and construction activities. 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 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. 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):

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	At September 30, 2013		At December 31, 2012	
	Outstanding	Estimated work remaining to complete	Outstanding	Estimated work remaining to complete
Surety Bonds:				
Surety bonds related to joint ventures	$87	$ 87	$87	$ 87
Surety bonds related to owned projects and lots under contract	165,852	85,828	87,305	38,936
Total surety bonds	$165,939	$ 85,915	$87,392	$ 39,023
Letters of Credit (“LOCs”):				
LOCs in lieu of deposits for contracted lots	$1,685	N/A	$—	N/A
LOCs for land development	34,289	N/A	32,475	N/A
LOCs for general corporate operations	4,500	N/A	4,991	N/A
Total LOCs	$40,474	N/A	$37,466	N/A

Accrued Liabilities. Accrued liabilities consist of the following (in thousands):

	At September 30, 2013	At December 31, 2012
Accruals related to real-estate development and construction activities	$32,954	$19,954
Payroll and other benefits	29,100	11,871
Accrued taxes	34,117	3,407
Warranty reserves	22,257	22,064
Legal reserves	16,807	16,067
Real-estate notes payable (1)	15,876	6,288
Other accruals	27,136	16,726
Total	$178,247	$96,377

(1) Reflects balance of non-recourse notes payable in connection with land purchases

Warranty Reserves. We provide home purchasers with limited warranties against certain building defects and 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 year 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 these reserves for the structural related warranty based on the number of homes still under warranty and historical warranty 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 may not be sufficient to draw a meaningful conclusion. We regularly review our warranty reserves and adjust them, as necessary, to reflect current claims pace and changes in trends as information becomes available. A summary of changes in our warranty reserves follows (in thousands):

	Three Months Ended September 30		Nine Months Ended September 30	
	2013	2012	2013	2012
Balance, beginning of period	$21,844	$21,243	$22,064	$23,136
Additions to reserve from new home deliveries	2,818	2,166	8,055	5,771
Warranty claims	(2,405)	(436)	(7,862)	(5,934)
Adjustments to pre-existing reserves	—	—	—	—
Balance, end of period	$22,257	$22,973	$22,257	$22,973

Warranty reserves are included in accrued liabilities on the accompanying consolidated balance sheets, and additions and adjustments to the reserves are included in cost of home closings within the accompanying 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

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with our contractual relationships and rights with our trades, are sufficient to cover our general warranty obligations. However, unanticipated changes in legal, weather, environmental or other conditions could have an impact on our actual warranty costs, and future costs could differ significantly from our estimates.

Recently Issued Accounting Pronouncements. In April 2013, the Financial Accounting Standards Board (“FASB”) issued ASU 2013-04, Liabilities ("ASU 2013-04"), which provides guidance for the recognition, measurement, and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation is fixed at the reporting date. ASU 2013-04 is effective for us beginning January 1, 2014. We do not anticipate the adoption of ASU 2013-04 to have an effect on our consolidated financial statements or disclosures.

NOTE 2 — REAL ESTATE AND CAPITALIZED INTEREST

Real estate consists of the following (in thousands):

	At September 30, 2013	At December 31, 2012
Homes under contract under construction (1)	$316,508	$192,948
Unsold homes, completed and under construction (1)	123,602	107,466
Model homes (1)	78,017	62,411
Finished home sites and home sites under development	721,492	634,106
Land held for development (2)	53,053	56,118
Land held for sale	19,630	21,650
Communities in mothball status (3)	32,912	38,488
	$1,345,214	$1,113,187

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

(2) 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 of a larger land parcel that we plan to build out over several years.

(3) Represents communities where we have decided to cease operations (mothball) as we have determined that their economic performance would be maximized by deferring development. In the future, some of these communities may be re-opened while others may be sold to third parties. If we deem our carrying value to not be fully recoverable, we adjust our carrying value for these assets to fair value at the time they are placed into mothball status. As of September 30, 2013, we had six mothballed communities with a carrying value of $29.6 million in our West Region and two mothballed communities with a carrying value of $3.3 million in our Central Region. We do not capitalize interest for such mothballed assets, and all ongoing costs of land ownership are also expensed as incurred.

As previously noted, in accordance with ASC 360-10, each of our land inventory and related real estate assets is reviewed for recoverability when impairment indicators are present as our inventory is considered “long-lived” in accordance with GAAP. In recent years, due to the volatile economic environment, we evaluate all of our real estate assets for impairment on a quarterly basis. ASC 360-10 requires impairment charges to be recorded if the asset is not deemed fully recoverable and the fair value of such assets is less than their carrying amounts. Our determination of fair value is based on projections and estimates. We also evaluate alternative product offerings in communities where impairment indicators are present and other strategies for the land exist, such as selling the land or holding the land for sale in the future. Based on these reviews of all our communities, we recorded real-estate impairment charges of $584,000 and $776,000 during the three and nine months ended September 30, 2013, respectively, as compared to $417,000 and $1.6 million for the same periods in 2012. These charges are included in Cost of closings in our income statements.

In the latter part of 2011, we announced our intent to wind-down operations in the Las Vegas, Nevada market. The remaining $11.8 million of assets we own in Nevada relate to properties that we are not currently developing and are either actively marketing for sale or have mothballed.

Subject to sufficient qualifying assets, we capitalize interest incurred in connection with the development and construction of real estate. Completed homes and land not actively under development do not qualify for interest capitalization. Capitalized interest is allocated to real estate when incurred and charged to cost of closings when the related property is delivered to our customers. To the extent our debt exceeds our qualified assets base, we expense a proportionate share of the interest incurred. A summary of our capitalized interest is as follows (in thousands):

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Capitalized interest, beginning of period	$26,294	$17,836	$21,600	$14,810
Interest incurred	12,508	11,654	37,876	33,819
Interest expensed	(3,462)	(5,009)	(13,113)	(18,718)
Interest amortized to cost of home and land closings	(6,342)	(4,296)	(17,365)	(9,726)
Capitalized interest, end of period (1)	$28,998	$20,185	$28,998	$20,185

(1) Approximately $511,000 and $539,000 of the capitalized interest is related to our joint venture investments and is a component of “Investments in unconsolidated entities” on our consolidated balance sheets as of September 30, 2013 and December 31, 2012, respectively.

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 our 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 the financial risk associated with land acquisitions and holdings and allow us to better maximize our liquidity.

Based on the provisions of the relevant accounting guidance, we have concluded that when we enter into purchase or option agreements 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, Consolidations, requires that for each VIE, we assess whether we are the primary beneficiary and, if we are, we 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 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 to acquire additional land into the VIE or dispose of land in the VIE 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 by determining 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 on behalf of the land owner and we bear any budget shortfalls and maintain any budget savings. 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 or contract at September 30, 2013 (dollars in thousands):

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	Number of Lots	Purchase Price	Option/Earnest Money Deposits Cash	
Purchase and option contracts recorded on balance sheet as Real estate not owned	20	$481	$ 135	
Option contracts not recorded on balance sheet - non-refundable deposits, committed (1)	3,075	231,338	22,771	
Purchase contracts not recorded on balance sheet — non-refundable deposits, committed (1)	3,048	153,414	9,759	
Purchase contracts not recorded on balance sheet — refundable deposits, committed	327	15,432	216	
Total committed (on and off balance sheet)	6,470	400,665	32,881	
Total purchase and option contracts not recorded on balance sheet — refundable deposits, uncommitted (2)	4,140	111,108	2,165	
Total lots under contract or option	10,610	$511,773	$ 35,046	
Total option contracts not recorded on balance sheet (3)	10,590	$511,292	$ 34,911	(4)

(1) Deposits are generally non-refundable except if certain contractual conditions fail or certain contractual obligations 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 option contracts recorded on our balance sheet as Real estate not owned, none of our option agreements require us to purchase lots.

(4) Amount is reflected in our consolidated balance sheet in the line item "Deposits on real estate under option or contract" as of September 30, 2013.

Generally, our option contracts 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. The pre-established number is typically structured to approximate our expected rate of home construction starts. Purchase contracts generally involved bulk purchase terms where we purchase all or a large portion of the lots at one time and are typically short-term in nature.

NOTE 4 — INVESTMENTS IN UNCONSOLIDATED ENTITIES

In the past, we have entered 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 them as critical to the success of our homebuilding operations and have not entered into any new land joint ventures since 2008. Based on the structure of these joint ventures, they may or may not be consolidated into our results. Our joint venture partners generally are 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 September 30, 2013, we had two active equity-method land development ventures.

For land development joint ventures, we, and in some cases our joint venture partners, usually receive an option or other similar arrangement to purchase portions of the land held by the joint venture. Option prices are generally negotiated prices that approximate market value when we enter into the option contract or similar arrangement. For these ventures, our share of the joint venture profit relating to lots we purchase from the joint ventures is deferred until homes are delivered by us and title passes to a homebuyer. Therefore, we allocate the portion of such joint venture profit to the land acquired by us as a reduction in the basis of the property.

In connection with our land development joint ventures, we may also provide certain types of guarantees to lenders financing the joint ventures. These guarantees can be classified into two categories: (i) Repayment Guarantees and (ii) Completion Guarantees, described in more detail below. Additionally, we have classified a guarantee related to our minority ownership in the South Edge joint venture separately, as there is pending litigation with the venture's lender group and other venture partners regarding that guarantee.

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(In thousands)	At September 30, 2013	At December 31, 2012
Repayment guarantees	$—	$219
Completion guarantees (1)	—	—
South Edge guarantee (2)	13,243	13,243
Total guarantees	$13,243	$13,462

(1) As our completion guarantees are typically backed by funding from a third party, we do not believe these guarantees represent a potential cash obligation for us, as they require only non-financial performance.

(2) See Note 13 regarding outstanding litigation related to a joint venture project known as “South Edge” or "Inspirada" and the corresponding reserves and charges we have recorded relating thereto.

Repayment Guarantees. We and/or our land development joint venture partners occasionally provide limited repayment guarantees on a pro rata basis on the debt of land development joint ventures. If such a guarantee were ever to be called or triggered, the maximum exposure to Meritage would generally be only our pro-rata share of the amount of debt outstanding that was in excess of the fair value of the underlying land securing the debt. Our share of these limited pro rata repayment guarantees as of September 30, 2013 and December 31, 2012 is presented in the table above (excluding any potential recoveries from the joint venture’s land assets).

Completion Guarantees. If there is development work to be completed, we and our joint venture partners are also typically obligated to the project lender(s) to complete construction of the land development improvements if the joint venture does not perform the required development. Provided we and the other joint venture partners are in compliance with these completion obligations, the project lenders are generally obligated to fund these improvements through any financing commitments available under the applicable joint venture development and construction loans.

In addition, we and our joint venture partners have from time to time provided unsecured indemnities to joint venture project lenders. These indemnities generally obligate us to reimburse the project lenders only for claims and losses related to matters for which such lenders are held responsible and our exposure under these indemnities is limited to specific matters such as environmental claims. A part of our project acquisition due diligence process is to determine potential environmental risks and generally we or the joint venture entity obtain an independent environmental review. Per the guidance of ASC 460-10, Guarantees, we believe these guarantees are either not applicable or not material to our financial results.

Surety Bonds. We and our joint venture partners also indemnify third party surety providers with respect to performance bonds issued on behalf of certain of our joint ventures. If a joint venture does not perform its obligations, the surety bond could be called. If these surety bonds are called and the joint venture fails to reimburse the surety, we and our joint venture partners may be obligated to make such payments. These surety indemnity arrangements are generally joint and several obligations with our joint venture partners. Although a majority of the required work may have been performed, these bonds are typically not released until all development specifications under the bond have been met. None of these bonds have been called to date and we believe it is unlikely that any of these bonds will be called or if called, that any such amounts would be material to us. See the table in Note 1 for more information on our surety bonds.

The joint venture obligations, guarantees and indemnities discussed above are generally provided by us or one of our subsidiaries. In joint ventures involving other homebuilders or developers, support for these obligations is generally provided by the parent companies of the joint venture partners. In connection with our periodic real estate impairment reviews, we may accrue for any such commitments where we believe our obligation to pay is probable and can be reasonably estimated. In such situations, our accrual represents the portion of the total joint venture obligation related to our relative ownership percentage. We continue to monitor these matters and reserve for these obligations if and when they become probable and can be reasonably estimated. Except as noted above and in Note 13 to these unaudited consolidated financial statements, as of September 30, 2013 and December 31, 2012, we did not have any such reserves.

We also participate in two mortgage and one title business joint ventures. The mortgage joint ventures are engaged in mortgage activities and they provide services to both our homebuyers ad well as other buyers. Although some of these

ventures originate mortgage loans, we have limited recourse related to any mortgages originated by these ventures. We intend to wind down the remaining title joint venture with the continued roll out of Carefree Title operations, as discussed earlier. Our investments in mortgage and title joint ventures as of September 30, 2013 and December 31, 2012 were $1.8 million and $2.0 million, respectively.

The joint venture financial information below represent the most recent information available to us.

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

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	At September 30, 2013	At December 31, 2012
Assets:		
Cash	$5,387	$7,650
Real estate	34,947	36,626
Other assets	3,188	3,478
Total assets	$43,522	$47,754
Liabilities and equity:		
Accounts payable and other liabilities	$4,696	$4,748
Notes and mortgages payable	13,389	14,001
Equity of:		
Meritage (1)	8,400	9,631
Other	17,037	19,374
Total liabilities and equity	$43,522	$47,754

	Three Months Ended September 30		Nine Months Ended September 30	
	2013	2012	2013	2012
Revenue	$8,975	$10,268	$25,373	$18,733
Costs and expenses	(3,256)	(3,711)	(9,466)	(8,250)
Net earnings of unconsolidated entities	$5,719	$6,557	$15,907	$10,483
Meritage's share of pre-tax earnings (1)(2)	$3,578	$2,975	$9,583	$6,626

(1) Balance represents Meritage's interest, as reflected in the financial records of the respective joint ventures. This balance may differ from the balance reflected 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) income deferrals as discussed in Note (2) below and (iv) the cessation of allocation of losses from joint ventures in which we have previously impaired 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 "Earnings/(loss) from other unconsolidated entities, net" on our consolidated income statements and excludes joint venture profit related to lots we purchased from the joint ventures. Such profit is deferred until homes are delivered by us and title passes to a homebuyer.

Our investments in unconsolidated entities include $0.6 million and $0.8 million at September 30, 2013 and December 31, 2012, respectively, related to the difference between the amounts at which our investments are carried and the amount of our portion of the venture's equity. These amounts are amortized as the assets of the respective joint ventures are sold. A de minimis amount of amortization was recorded for these assets in the three and nine months ended September 30, 2013 with no amortization recorded for the same periods in 2012.

The joint venture assets and liabilities noted in the table above primarily represent two active land ventures, two mortgage ventures, one title venture and various inactive ventures in which we have a total investment of $10.7 million. As of September 30, 2013, we believe these ventures are in compliance with their respective debt agreements, if applicable, and such debt is non-recourse to us.

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NOTE 5 — SENIOR, SENIOR SUBORDINATED, CONVERTIBLE SENIOR NOTES AND OTHER BORROWINGS

Senior, senior subordinated, convertible senior notes and other borrowings consist of the following (in thousands):

	At September 30, 2013	At December 31, 2012
7.731% senior subordinated notes due 2017	$—	$99,825
4.50% senior notes due 2018	175,000	—
7.15% senior notes due 2020. At September 30, 2013 and December 31, 2012, there was approximately $3,163 and $3,528 in unamortized discount, respectively	196,837	196,472
7.00% senior notes due 2022	300,000	300,000
1.875% convertible senior notes due 2032	126,500	126,500
$135 million unsecured revolving credit facility	—	—
	$798,337	$722,797

The indentures for our 4.50%, 7.15% and 7.00% senior notes (collectively, "the 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. Our convertible senior notes do not have any financial covenants.

Borrowings under our unsecured revolving credit facility ("the Credit Facility") are 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 $360.0 million (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. No amounts were drawn under the Credit Facility as of September 30, 2013 or December 31, 2012.

In March 2013, we completed an offering of $175 million aggregate principal amount of 4.50% Senior Notes due 2018. Concurrent with this offering, we announced a tender offer to repurchase all of our 7.731% Senior Subordinated Notes due 2017 ("2017 Notes") and subsequently issued a call offer to repurchase any and all remaining notes not tendered. As a result of the tender offer, as of September 30, 2013, we had repurchased all of the $99.8 million outstanding 2017 Notes. The debt redemption transactions resulted in costs and charges of $3.8 million for the nine months ended September 30, 2013 reflected as Loss on early extinguishment of debt in our consolidated income statements.

In June 2013, we amended our existing Credit Facility, to among other things, extend the facility maturity date by one year from July 24, 2015 to July 24, 2016, amend the formula for calculating the borrowing base to moderately increase the advance rate for certain categories of assets and to increase the accordion feature to $75 million. In addition, two additional lenders joined the Credit Facility lending syndicate, thereby increasing the total commitment currently available under the Credit Facility to $135 million.

Obligations to pay principal and interest on our notes listed in the table above are guaranteed by 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 will 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

nonguarantor subsidiaries, if any, are, individually and in the aggregate, inconsequential.

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NOTE 6 — FAIR VALUE DISCLOSURES

We account for the non-recurring fair value measurements of our non-financial assets and liabilities in accordance with ASC 820-10, Fair Value Measurement and Disclosure. 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.

If the only observable inputs are from inactive markets or for transactions which the company evaluates as “distressed”, the use of Level 1 inputs should be modified by the company to properly address these factors, or the reliance of such inputs may be limited, with a greater weight attributed to Level 3 inputs. Refer to Notes 1 and 2 for additional information regarding the valuation of our non-financial assets.

Due to our quarterly review of our long-lived real-estate assets as described in Note 2, we consider the carrying amounts of real-estate assets subject to current period impairments to approximate fair value, although all such adjustments for the three and nine months ended September 30, 2013 and September 30, 2012 were considered immaterial.

Financial Instruments. The fair value of our fixed-rate debt is derived from quoted market prices by independent dealers and is as follows (in thousands):

		September 30, 2013		December 31, 2012	
	Hierarchy	Aggregate Principal	Estimated Fair Value	Aggregate Principal	Estimated Fair Value
7.731% senior subordinated notes	Level 2	N/A	N/A	$99,825	$102,950
4.50% senior notes	Level 2	$175,000	$171,938	N/A	N/A
7.15% senior notes	Level 2	$200,000	$216,000	$200,000	$220,760
7.00% senior notes	Level 2	$300,000	$318,000	$300,000	$328,500
1.875% convertible senior notes	Level 2	$126,500	$135,829	$126,500	$127,449

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

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NOTE 7 — EARNINGS PER SHARE

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

	Three Months Ended September 30		Nine Months Ended September 30	
	2013	2012	2013	2012
Basic weighted average number of shares outstanding	36,226	35,216	36,060	33,541
Effect of dilutive securities:				
Convertible debt (1)	2,176	—	2,176	—
Stock options and unvested restricted stock	463	545	535	469
Diluted weighted average shares outstanding	38,865	35,761	38,771	34,010
Net earnings as reported	$38,191	$6,784	$78,375	$10,035
Interest attributable to convertible senior notes, net of income taxes	393	—	1,180	—
Net earnings for earnings per share	$38,584	$6,784	$79,555	$10,035
Basic earnings per share	$1.05	$0.19	$2.17	$0.30
Diluted earnings per share (1)	$0.99	$0.19	$2.05	$0.30
Antidilutive stock options not included in the calculation of diluted income per share	10	530	5	348

(1) In the third quarter of 2012, we issued $126.5 million of 1.875% convertible senior notes convertible into shares of our common stock at a rate of 17.1985 shares per $1,000 principle amount. In accordance with ASC Subtopic 260-10, Earnings Per Share, ("ASC 260-10") we calculate the dilutive effect of convertible securities using the "if-converted" method.

NOTE 8 — STOCKHOLDERS' EQUITY

A summary of changes in shareholders' equity is presented below:

	Nine Months Ended September 30, 2013 (In thousands)				
	Number of Shares	Common Stock	Additional Paid-In Capital	Retained Earnings	Total
Balance at December 31, 2012	35,613	$356	$390,249	$303,605	$694,210
Net earnings	—	—	—	78,375	78,375
Exercise of stock options	335	3	11,222	—	11,225
Excess income tax benefit from stock-based awards	—	—	1,733	—	1,733
Equity award compensation expense	—	—	7,040	—	7,040
Issuance of restricted stock	283	3	(3)	—	—
Non-controlling interest acquisition	—	—	(257)	—	(257)
Balance at September 30, 2013	36,231	$362	$409,984	$381,980	$792,326

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	Nine Months Ended September 30, 2012 (In thousands)					
	Number of Shares	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Total
Balance at December 31, 2011	40,377	$404	$478,839	$198,442	$(188,773)	$488,912
Net earnings	—	—	—	10,035	—	10,035
Exercise of stock options	259	3	3,897	—	—	3,900
Equity award compensation expense	—	—	6,095	—	—	6,095
Issuance of restricted stock	200	2	(2)	—	—	—
Issuance of stock (1)	2,645	26	87,099	—	—	87,125
Cancellation of treasury shares (2)	(7,891)	(79)	(188,694)	—	188,773	—
Balance at September 30, 2012	35,590	356	387,234	208,477	—	596,067

(1) In July 2012, we issued a public offering of 2,645,000 shares of common stock, par value $0.01 per share, at a price to the public of $34.75 per share.

(2) During the third quarter of 2012, we canceled and retired all of our treasury shares. These shares remain as authorized and unissued shares.

NOTE 9 — STOCK-BASED COMPENSATION

We have a stock compensation plan, the 2006 Stock Option Plan (the “Plan”), that was adopted in 2006, and superseded a prior stock compensation plan. The Plan has been amended from time to time. The Plan was approved by our stockholders and is administered by our Board of Directors. The provisions of the Plan allow for the grant of stock appreciation rights, restricted stock awards, performance share awards and performance-based awards in addition to non-qualified and incentive stock options. The Plan authorizes awards to officers, key employees, non-employee directors and consultants for up to 8,950,000 shares of common stock, of which 967,743 shares remain available for grant at September 30, 2013. We believe that such awards provide a means of performance-based compensation to attract and retain qualified employees and better align the interests of our employees with those of our stockholders. Non-vested stock awards and stock options granted in previous years are typically granted with a five-year ratable vesting period. Non-vested stock awards and performance-based awards granted to our executive management team and our Board of Directors are typically granted with a three-year cliff vesting.

Compensation cost related to time-based restricted stock awards are measured as of the closing price on the date of grant and are expensed on a straight-line basis over the vesting period of the award. Compensation cost related to performance-based restricted stock awards are also measured as of the closing price on the date of grant but are expensed in accordance with ASC 718-10-25-20, Compensation – Stock Compensation, which requires an assessment of probability of attainment of the performance target. As our performance targets are annual in nature, once we determine that the performance target outcome is probable, the year-to-date expense is recorded and the remaining expense is recorded on a straight-line basis through the end of the award’s vesting period.

Below is a summary of compensation expense and stock award activity (dollars in thousands):

	Three Months Ended September 30		Nine Months Ended September 30	
	2013	2012	2013	2012
Stock-based compensation expense	$3,099	$2,822	$7,040	$6,095
Non-vested shares granted	3,600	16,750	345,700	386,500
Performance-based non-vested shares granted	—	—	62,500	56,250
Stock options exercised	12,400	179,832	334,500	259,132

Restricted stock awards vested (includes performance-based awards)	2,550	3,300	283,350	200,316

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We did not grant any stock option awards during the nine months ended September 30, 2013 or September 30, 2012. The following table includes additional information regarding the Plan (dollars in thousands):

	As of September 30, 2013	December 31, 2012
Unrecognized stock-based compensation cost	$19,529	$13,072
Weighted average years remaining vesting period	2.40	2.17
Total equity awards outstanding (1)	1,328,885	1,615,235

(1) Includes vested and unvested options outstanding and unvested restricted stock awards.

NOTE 10 — INCOME TAXES

Components of the income tax (provision)/benefit are as follows (in thousands):

	Three Months Ended September 30		Nine Months Ended September 30	
	2013	2012	2013	2012
Federal				