

THIS QUARTERLY REPORT IS BEING PREPARED PURSUANT TO REQUIREMENTS CONTAINED IN THE INDENTURE, DATED AS OF MARCH 27, 2019 GOVERNING THE 9.875% SENIOR NOTES DUE 2027 ISSUED BY ASHTON WOODS USA L.L.C. AND IN THE INDENTURE, DATED AS OF AUGUST 8, 2017 GOVERNING THE 6.750% SENIOR NOTES DUE 2025 ISSUED BY ASHTON WOODS USA L.L.C.

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

For the quarterly period ended November 30, 2019

OR

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

For the transition period from _____ to _____.

Commission file Number: N/A

Ashton Woods USA L.L.C.

(Exact Name of Registrant as Specified in Its Charter)

Nevada

(State or Other Jurisdiction of Incorporation or Organization)

37-1590746

(I.R.S. Employer Identification No.)

3820 Mansell Road, Suite 400
Alpharetta, GA

(Address of Principal Executive Offices)

30022

(Zip Code)

(770) 998-9663

Registrant's telephone number, including area code

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class

NONE

Securities registered pursuant to Section 12(g) of the Act:

Title of Each Class

NONE

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Emerging growth company

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

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

ASHTON WOODS USA L.L.C.
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Ernst & Young LLP
Suite 1000
55 Ivan Allen Jr. Boulevard
Atlanta, GA 30308

Tel: +1 404 874 8300
Fax: +1 404 817 5589
ey.com

Review Report of Independent Auditors

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

We have reviewed the condensed consolidated financial information of Ashton Woods USA L.L.C., which comprise the condensed consolidated balance sheet as of November 30, 2019, and the related condensed consolidated statements of income for the three- and six-month periods ended November 30, 2019 and 2018, condensed consolidated statements of changes in members' equity for each of the three-month periods in the period from May 31, 2018 to November 30, 2019, and condensed consolidated statements of cash flows for the six-month periods ended November 30, 2019 and 2018.

Management's Responsibility for the Financial Information

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

Auditor's Responsibility

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

Conclusion

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

Report on Condensed Consolidated Balance Sheet as of May 31, 2019

We have previously audited, in accordance with auditing standards generally accepted in the United States, the consolidated balance sheet of Ashton Woods USA L.L.C. as of May 31, 2019, and the related consolidated statements of income, changes in members' equity, and cash flows for the year then ended (not presented herein); and we expressed an unmodified audit opinion on those audited consolidated financial statements in our report dated July 17, 2019. In our opinion, the accompanying condensed consolidated balance sheet of Ashton Woods USA L.L.C. as of May 31, 2019, is consistent, in all material respects, with the consolidated balance sheet from which it has been derived.

Ernst & Young LLP

January 8, 2020

PART I. FINANCIAL INFORMATION

Item 1. *Financial Statements*

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

	<u>November 30,</u> <u>2019</u>	<u>May 31,</u> <u>2019</u>
Assets:		
Cash and cash equivalents	\$ —	\$ —
Restricted cash	84	189
Receivables	27,161	25,716
Inventory	1,017,048	874,240
Property and equipment, net	13,556	14,448
Investments in unconsolidated entities	2,949	5,260
Deposits on real estate under option or contract	128,509	122,329
Other assets	104,542	88,134
Total assets	<u>\$ 1,293,849</u>	<u>\$ 1,130,316</u>
Liabilities and members' equity:		
Liabilities:		
Accounts payable	\$ 88,125	\$ 87,543
Other liabilities	126,236	119,992
Customer deposits	24,316	20,816
Debt	660,538	514,868
Total liabilities	<u>899,215</u>	<u>743,219</u>
Commitments and contingencies (Note 12)		
Members' equity	<u>394,634</u>	<u>387,097</u>
Total liabilities and members' equity	<u>\$ 1,293,849</u>	<u>\$ 1,130,316</u>

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
	(Unaudited)			
Revenues:				
Home sales	\$ 375,974	\$ 336,340	\$ 739,409	\$ 692,144
Land sales	5,970	2,239	5,970	2,314
Financial services and other revenues	12,651	1,253	14,979	2,750
	<u>394,595</u>	<u>339,832</u>	<u>760,358</u>	<u>697,208</u>
Cost of sales:				
Cost of sales homes	308,694	278,122	613,869	570,582
Cost of sales land	4,501	1,963	4,529	2,861
Cost of sales financial services and other revenues	10,390	—	10,390	—
	<u>323,585</u>	<u>280,085</u>	<u>628,788</u>	<u>573,443</u>
Gross profit	71,010	59,747	131,570	123,765
Other expense (income):				
Selling, general and administrative	53,355	47,567	107,177	95,729
Interest expense	3,170	1,817	5,946	3,713
Depreciation and amortization	2,656	2,678	5,008	5,387
Other income	(27)	(326)	(612)	(232)
	<u>59,154</u>	<u>51,736</u>	<u>117,519</u>	<u>104,597</u>
Equity in earnings of unconsolidated entities	1,083	657	2,051	1,381
Net income	<u>\$ 12,939</u>	<u>\$ 8,668</u>	<u>\$ 16,102</u>	<u>\$ 20,549</u>

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Class A interest	Class B interests	Class C interests	Total members' equity
Members' equity at May 31, 2018 (Audited)	\$ 129,206	\$ 28,033	\$ 190,670	\$ 347,909
Net income	4,623	1,136	6,122	11,881
Distributions	(5,201)	(1,278)	(6,886)	(13,365)
Members' equity at August 31, 2018 (Unaudited)	\$ 128,628	\$ 27,891	\$ 189,906	\$ 346,425
Net income	3,373	829	4,466	8,668
Distributions	(2,335)	(574)	(3,091)	(6,000)
Members' equity at November 30, 2018 (Unaudited)	\$ 129,666	\$ 28,146	\$ 191,281	\$ 349,093
Net income	3,173	780	4,201	8,154
Members' equity at February 28, 2019 (Unaudited)	\$ 132,839	\$ 28,926	\$ 195,482	\$ 357,247
Net income	12,410	3,050	16,430	31,890
Distributions	(794)	(195)	(1,051)	(2,040)
Members' equity at May 31, 2019 (Audited)	\$ 144,455	\$ 31,781	\$ 210,861	\$ 387,097
Net income	1,231	302	1,630	3,163
Distributions	(2,704)	(665)	(3,581)	(6,950)
Members' equity at August 31, 2019 (Unaudited)	\$ 142,982	\$ 31,418	\$ 208,910	\$ 383,310
Net income	5,035	1,237	6,667	12,939
Distributions	(628)	(155)	(832)	(1,615)
Members' equity at November 30, 2019 (Unaudited)	\$ 147,389	\$ 32,500	\$ 214,745	\$ 394,634

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Six months ended November 30,	
	2019	2018
	(Unaudited)	
Cash flows from operating activities:		
Net income	\$ 16,102	\$ 20,549
Adjustments to reconcile net income to net cash used in operating activities:		
Equity in earnings of unconsolidated entities	(2,051)	(1,381)
Returns on investments in unconsolidated entities	2,752	1,348
Long-term compensation expense	2,543	1,223
Inventory impairments	592	2,718
Depreciation and amortization	5,008	5,387
Changes in operating assets and liabilities:		
Inventory	(142,008)	(134,877)
Receivables	(1,445)	(2,392)
Deposits on real estate under option or contract	(6,180)	(29,507)
Other assets	422	13,100
Accounts payable	582	30,493
Other liabilities	(11,781)	(20,890)
Customer deposits	3,500	(2,378)
Net cash used in operating activities	<u>(131,964)</u>	<u>(116,607)</u>
Cash flows from investing activities:		
Returns of investments in unconsolidated entities	1,860	25
Additions to property and equipment	(4,486)	(4,180)
Net cash used in investing activities	<u>(2,626)</u>	<u>(4,155)</u>
Cash flows from financing activities:		
Borrowings from revolving credit facility	586,700	549,000
Repayments of revolving credit facility	(441,770)	(436,547)
Payment of debt issuance costs	(1,880)	—
Members' distributions	(8,565)	(19,365)
Net cash provided by financing activities	<u>134,485</u>	<u>93,088</u>
Change in cash, cash equivalents, and restricted cash	(105)	(27,674)
Cash, cash equivalents, and restricted cash, beginning of period	<u>189</u>	<u>27,718</u>
Cash, cash equivalents, and restricted cash, end of period	<u>\$ 84</u>	<u>\$ 44</u>
Supplemental cash flow information:		
Cash paid for interest, net of amounts capitalized	<u>\$ 4,831</u>	<u>\$ 3,790</u>

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

The following table provides a reconciliation of cash, cash equivalents, and restricted cash reported within the unaudited condensed consolidated balance sheets to the total of the same such amounts shown above:

	As of November 30,	
	2019	2018
Cash and cash equivalents	\$ —	\$ —
Restricted cash	84	44
Total cash, cash equivalents, and restricted cash	\$ 84	\$ 44

Supplemental disclosures of cash flows information:

	As of November 30,	
	2019	
Right-of-use assets obtained in exchange for new operating lease liabilities	\$	24.8

See accompanying notes to unaudited condensed consolidated financial statements.

ASHTON WOODS USA L.L.C.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
November 30, 2019

Note 1 — Basis of Presentation and Significant Accounting Policies

(a) Operations

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

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

The Company offers title services to its homebuyers in its Austin, Dallas, Houston, San Antonio, Raleigh, Orlando, Southwest Florida, and Atlanta operating divisions through two wholly-owned title agencies.

In addition, the Company offers residential mortgage services to its homebuyers and the public at large in Austin, Dallas, Houston, San Antonio, Charleston, Raleigh, Orlando, Phoenix, and Southwest Florida through an unconsolidated mortgage joint venture. The Company has an ownership interest of 49% in this mortgage joint venture.

(b) Basis of presentation

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

(c) Cash, cash equivalents, and restricted cash

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

(d) Inventory

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

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

Inventory is stated at cost, unless the carrying amount is determined not to be recoverable, in which case the inventory is written down to fair value in accordance with Financial Accounting Standards Board (“FASB”) Accounting Standards

Codification (“ASC”) Subtopic 360-10, *Property, Plant and Equipment* (“ASC 360-10”). The Company reviews its inventory in accordance with ASC Subtopic 360-10, which requires long-lived assets to be assessed for impairment when facts and circumstances indicate an impairment may exist. The Company utilizes an undiscounted future cash flow model in this assessment. When the results of the undiscounted future cash flows are less than the carrying value of the community (asset group), an asset impairment must be recognized in the unaudited condensed consolidated financial statements as a component of cost of sales. The amount of the impairment is calculated by subtracting the estimated fair value of the community, less cost to sell, from the carrying value. ASC Subtopic 360-10 also requires that assets held for sale be stated at the lower of cost or fair value, as determined based on active negotiations with market participants, less costs to sell. Accordingly, land held for sale is stated at the lower of accumulated cost or fair value less costs to sell.

Based on the Company's review of its inventory for impairment during the six months ended November 30, 2019, inventory impairment charges totaling \$0.6 million were recognized. The inventory impairment charge of \$0.6 million consisted of \$419.8 thousand of impairments on homes in inventory, which is included as a component of cost of sales – homes in the unaudited condensed consolidated statements of income, and \$172.4 thousand of impairments on land that was held for sale, which is included as a component of cost of sales – land in the unaudited condensed consolidated statements of income. The Company recorded inventory impairment charges of \$2.7 million during the six months ended November 30, 2018, which consisted of \$1.9 million of impairments on homes in inventory, which is included as a component of cost of sales – homes in the unaudited condensed consolidated statements of income, and \$0.8 million of impairments of land that was held for sale, which is included as a component of cost of sales – land in the unaudited condensed consolidated statements of income.

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

(e) Receivables

Receivables at November 30, 2019 and May 31, 2019 consisted of the following (in thousands):

	November 30, 2019	May 31, 2019
Closing funds due	\$ 590	\$ 4,849
Land development receivables	11,805	7,770
MUD receivables ⁽¹⁾	8,296	7,349
Other receivables ⁽²⁾	6,470	5,748
	<u>\$ 27,161</u>	<u>\$ 25,716</u>

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

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

(f) Real estate not owned

Real estate not owned reflects the future purchase price of lots under option purchase agreements pursuant to ASC 606, *Revenue From Contracts With Customers* (“ASC 606”), ASC Subtopic 470-40 (“ASC 470-40”), *Product Financing Arrangements*, or ASC 810, *Consolidation* (“ASC 810”) (see Note 4).

(g) Investments in unconsolidated entities

The Company participates in one land development joint venture in which it has less than a controlling interest. The Company accounts for its interest in this entity under the equity method. The Company's share of profits from lots it purchases from this joint venture is deferred and treated as a reduction of the cost basis of land purchased from the entity.

The Company offers residential mortgage services to its homebuyers and the public at large in Austin, Dallas, Houston, San Antonio, Charleston, Raleigh, Orlando, Phoenix, and Southwest Florida through an unconsolidated mortgage joint venture. The Company has an ownership interest of 49% in this mortgage joint venture. The Company's investment in this mortgage joint venture is accounted for under the equity method.

Investments in unconsolidated entities are evaluated for other-than-temporary impairment during each reporting period pursuant to ASC Subtopic 323-10, *Investments—Equity Method and Joint Ventures*. A series of operating losses or other factors may indicate an other-than-temporary decrease in the value of the Company's investment in the unconsolidated entity. The amount of impairment recognized is the excess of the investment's carrying value over its estimated fair value. The Company did not recognize any other-than-temporary impairment during the six months ended November 30, 2019 and 2018 related to its investments in unconsolidated entities.

(h) Deposits and pre-acquisition costs

Deposits and pre-acquisition costs related to purchase agreements are capitalized when paid and classified in the unaudited condensed consolidated balance sheets as deposits on real estate under option or contract (for deposits) and other assets (for pre-acquisition costs) until the related land is acquired. These costs are transferred to inventory at the time the land or lots are acquired. Nonrefundable deposits and pre-acquisition costs are charged to expense when the real estate purchase is no longer considered probable. If the Company intends to terminate a purchase agreement, it records a charge to earnings for the costs associated with the purchase agreement in the period such a decision is made. This expense is included as a component of cost of sales – homes in the unaudited condensed consolidated statements of income and totaled \$0.2 million and \$0.9 million for the three and six months ended November 30, 2019, respectively, and \$0.7 million and \$1.2 million for the three and six months ended November 30, 2018, respectively.

(i) Property and equipment

Property and equipment is recorded at cost. Depreciation and amortization is generally recorded using the straight-line method over the estimated useful lives of the assets, which range from two to five years. Depreciable lives for leasehold improvements reflect the lesser of the economic life of the asset or the term of the lease. Repairs and maintenance costs are expensed as incurred. The Company's property and equipment at November 30, 2019 and May 31, 2019 consisted of the following (in thousands):

	November 30, 2019	May 31, 2019
Office furniture and equipment	\$ 4,200	\$ 4,109
Sales offices, design studios, and model furnishings	36,687	37,562
Leasehold improvements	2,608	2,117
	43,495	43,788
Accumulated depreciation and amortization ⁽¹⁾	(29,939)	(29,340)
	<u>\$ 13,556</u>	<u>\$ 14,448</u>

(1) Net of retirements and disposals.

Depreciation and amortization expense approximated \$2.7 million and \$5.0 million for the three and six months ended November 30, 2019, respectively, and \$2.7 million and \$5.4 million for the three and six months ended November 30, 2018, respectively.

(j) Revenue recognition

On June 1, 2018, the Company adopted ASC 606 applying the modified retrospective method to contracts that were not completed as of June 1, 2018. As a result of our adoption of ASU 2014-09, our accounting policies for revenue recognition are as follows:

With respect to home sale revenues, revenue from a home sale is recognized when we have satisfied the performance obligation in the home sales contract, which is generally at the time of the closing of each sale, when title to and possession of the property are transferred to the buyer. The revenue recognized for each home sale includes the base sales price of the home, as well as any purchased options and upgrades and is reduced for any sales price incentives. Our performance obligation to deliver the agreed-upon home is generally satisfied in less than one year from the original contract date. Home sale contract assets consist of cash from home closings in transit or held in escrow for our benefit, which is typically received within two days of the home closing. Home sale contract assets totaled \$0.6 million and \$4.8 million at November 30, 2019 and May 31, 2019, respectively, and are classified as receivables in the unaudited condensed consolidated balance sheets. Home sale contract liabilities include customer deposit liabilities related to sold but undelivered homes, which totaled \$24.3 million and \$20.8 million at November 30, 2019 and May 31, 2019, respectively. Of the customer deposit liabilities at May 31, 2019 and 2018, \$15.2 million and \$21.4 million, respectively, was recognized in revenues in the six months ended November 30, 2019 and 2018, respectively, upon the closing of the related homes. Also included in home sale revenues are our wholesale home sales within our Starlight Homes brand in existing markets. Wholesale home sales are primarily sold under a bulk sales agreement to real estate investors who intend to use the homes as rental properties. The Company's adoption of ASC 606 did not result in a change in the classification of home sale revenues on the unaudited condensed consolidated statements of income. See Note 1(I) for additional discussion of warranties and obligations associated with home sales revenue.

With respect to land sale revenues, we periodically elect to sell parcels of land or lots. These land and lot sales are generally outright sales of specified land parcels with cash consideration due on the closing date, which is generally when performance obligations are satisfied. Land sale contract assets consist of cash from closed land sales in transit or held in escrow for our benefit, which is typically received within two days of closing on the land sale. Land sale contract assets are classified as receivables in the unaudited condensed consolidated balance sheets. Land sale contract liabilities consist of customer deposit liabilities related to land parcels under contract for sale. Land sale contract assets and liabilities were immaterial at November 30, 2019 and May 31, 2019. The Company's adoption of ASU 2014-09 did not result in a change in the classification of land sale revenues on the unaudited condensed consolidated statements of income.

Finally, with respect to financial services and other revenues, financial services revenues, which are not within the scope of ASC 606, primarily consist of title premium income earned from the provision of title services for homebuyers. Other revenues consists of revenue from forfeited customer deposits that is recognized upon cancellation of the home sales contract when the Company is contractually entitled to retain the deposit and other miscellaneous customer revenue that is recognized when the related performance obligation is satisfied. Other revenue also includes revenue from fee development, development oversight, and/or construction agreements entered into by the Company with third-party property owners. For these types of contracts, the Company recognizes revenue based on the actual total costs it has incurred plus the applicable fee. In accordance with ASC 606, the Company applies the percentage-of-completion method, using the cost-to-cost approach, as it most accurately measures the progress of our efforts in satisfying our obligations within the fee building agreements. Under this approach, revenue is earned in proportion to total costs incurred divided by total costs expected to be incurred. In the course of providing fee development, development oversight, and/or construction services, the Company routinely subcontracts for services and incurs other direct costs. These costs are typically passed through to the property owners and, in accordance with GAAP, are included in the Company's financial services and other revenues and cost of sales financial services and other revenues on the consolidated statements of income. Financial services and other revenues, which are within the scope of ASC 606, were previously classified as other expense/(income) on the consolidated statements of income, but are classified as revenue, effective June 1, 2018.

ASC 606 provides certain practical expedients that limit some accounting treatments and disclosure requirements. Accordingly, we do not disclose the value of unsatisfied performance obligations for contracts with an original expected length of one year or less. In addition, the expected revenue to be recognized in any future year relating to unsatisfied performance obligations with an original expected length greater than one year is not material.

See Note 2 and Note 12 for further discussion of the impact of the adoption of ASU 2014-09.

(k) Prepaid expenses

Included in other assets are prepaid expenses of approximately \$6.0 million and \$7.9 million as of November 30, 2019 and May 31, 2019, respectively, which primarily represent prepaid insurance, fees, permits, and rent.

(l) Warranty costs

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

Presented below are summaries of the activity in the Company's warranty liability account for the three and six months ended November 30, 2019 and 2018 (in thousands):

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
Warranty liability, beginning of period	\$ 10,693	\$ 9,892	\$ 11,933	\$ 10,342
Costs accrued during period	2,766	2,755	5,315	5,358
Costs incurred during period	(3,801)	(2,855)	(7,590)	(5,908)
Warranty liability, end of period	\$ 9,658	\$ 9,792	\$ 9,658	\$ 9,792

(m) Advertising costs

The Company expenses advertising costs as they are incurred. Advertising expense, which is included in selling, general and administrative expenses in the unaudited condensed consolidated statements of income, was approximately \$3.2 million and \$6.8 million for the three and six months ended November 30, 2019, respectively, and \$2.8 million and \$5.1 million for the three and six months ended November 30, 2018, respectively.

(n) Long-term incentive plan

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

(o) Income taxes

The Company operates as a limited liability company and is treated as a partnership for income tax purposes. Accordingly, the Company incurs no liability for federal or state income taxes, since the taxable income or loss is passed through to its Members, but incurs liabilities for certain state taxes payable directly by the Company. The Company calculates its Members' potential tax liability related to their share of the Company's taxable income and may make distributions to such Members to allow them to satisfy their tax liability, subject to limitations contained in the Company's senior secured revolving credit facility and in the indentures governing its 9.875% Senior Notes due 2027 (the "9.875%

Notes”) and its 6.750% Senior Notes due 2025 (the “6.750% Notes”). Any tax distributions made to the Members are treated as a reduction of equity. The Company made tax distributions to its Members of \$8.6 million and \$19.4 million during the six months ended November 30, 2019 and 2018, respectively.

(p) Use of estimates

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

(q) Segments

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

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

The Company has determined that the homebuilding operating markets within its respective reportable segments have similar economic characteristics and product types, and are similar in terms of geography. The Company’s homebuilding operating markets also share all other relevant aggregation characteristics prescribed in ASC 280, such as similar product types, production processes and methods of distribution. See Note 13 for further discussion of the Company’s reportable segments.

(r) Subsequent events

The Company has evaluated subsequent events through January 8, 2020. This date represents the date on which the unaudited condensed consolidated financial statements were available to be issued.

On January 8, 2020, the Board of Directors of the Company approved tax distributions of \$3.9 million to its Members based on estimates of its Members' tax liabilities related to their share of the Company's taxable income.

Note 2 — Pending and Recently Adopted Accounting Pronouncements

In May 2014, the FASB issued ASC 606, which is a comprehensive revenue recognition model that replaced most existing revenue recognition guidance. ASC 606 states that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. As discussed in Note 1(j), on June 1, 2018, the Company adopted ASC 606, applying the modified retrospective method to contracts that were not completed as of June 1, 2018. Results for reporting periods beginning after June 1, 2018, are presented under ASC 606, while prior period amounts have not been adjusted and continue to be reported under the previous accounting standards. There was no material impact to revenues or net income as a result of the application of ASC 606 for the three and six months ended November 30, 2019 and 2018, and there have not been significant changes to our business processes or systems as a result of implementing the standard. See Note 1(j) for further discussion of the Company's revenue recognition policy under ASC 606.

In February 2016, the FASB issued ASU No. 2016-02, *Leases* (“ASU 2016-02”), which requires, among other things, that lessees recognize the operating lease right-of-use assets and operating lease liabilities (“Lease Liabilities”) arising from operating leases on the balance sheet. On June 1, 2019, the Company adopted ASU 2016-02 and related amendments using a modified retrospective approach with an effective date as of June 1, 2019. Prior year financial statements were not required to be recast under the new standard and, therefore, have not been reflected as such on our unaudited condensed consolidated balance sheet. We elected the package of transitional practical expedients, which allowed us to carryforward our historical assessment of (1) whether contracts are or contain leases, (2) lease classification, and (3) initial direct costs. Additionally, we have elected to apply the standard's practical expedients which allow us to (1) continue to apply existing accounting policies for all land easements that existed or expire before the date of adoption, (2) not recognize right-of-use assets or Lease liabilities for leases that qualify as short-term leases for all classes of underlying assets, and

(3) not separate lease and non-lease components for all classes of underlying assets. The Company did not elect to apply the hindsight practical expedient when determining the term for our leases. The new standard requires disclosure of additional quantitative and qualitative information for our lease arrangements. These additional disclosures are included in Note 12.

In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* (“ASU 2016-13”), which changes the impairment model for most financial assets and certain other instruments from an “incurred loss” approach to a new “expected credit loss” methodology. The effective date of ASU 2016-13 was amended by the release of ASU 2019-10 in November 2019 and was extended to fiscal years beginning after December 15, 2022, and for annual and interim periods thereafter. The standard requires an entity to recognize the affects of adopting the new standard as a cumulative effect adjustment to opening retained earnings in the period of adoption. The Company is currently evaluating the impact that adoption of ASU 2016-13 will have on its consolidated financial statements and related disclosures.

Note 3 — Inventory

Inventory consisted of the following at November 30, 2019 and May 31, 2019 (in thousands):

	November 30, 2019	May 31, 2019
Homes under construction and finished homes	\$ 723,128	\$ 596,312
Finished lots	189,731	194,129
Land under development	89,305	61,314
Land held for future development	13,842	20,303
Land held for sale	1,042	2,172
Commercial land	—	10
	<u>\$ 1,017,048</u>	<u>\$ 874,240</u>

The Company capitalizes all interest incurred to the extent its qualifying assets meet or exceed its debt obligations. If qualifying assets are less than the Company’s debt obligations, there are limits on the amount of interest that can be capitalized, and the remainder of interest incurred must be directly expensed. The Company directly expensed interest of \$3.2 million and \$5.9 million for the three and six months ended November 30, 2019, respectively, and \$1.8 million and \$3.7 million for the three and six months ended November 30, 2018, respectively, in the unaudited condensed consolidated statements of income.

The following table summarizes interest costs incurred, charged to cost of sales and directly expensed during the three and six months ended November 30, 2019 and 2018 (in thousands):

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
Capitalized interest, beginning of period	\$ 20,484	\$ 15,545	\$ 19,040	\$ 13,824
Interest incurred	13,471	11,051	26,434	21,372
Interest amortized to cost of sales	(8,462)	(6,530)	(17,205)	(13,234)
Interest expensed	(3,170)	(1,817)	(5,946)	(3,713)
Capitalized interest, end of period	<u>\$ 22,323</u>	<u>\$ 18,249</u>	<u>\$ 22,323</u>	<u>\$ 18,249</u>

Note 4 — Other Assets

Other assets at November 30, 2019 and May 31, 2019 consisted of the following (in thousands):

	November 30, 2019	May 31, 2019
Real estate not owned	\$ 65,437	\$ 64,733
Right-of-use assets ⁽¹⁾	15,232	—
Prepaid expenses	5,957	7,929
Architecture plans	5,464	5,848
Deferred financing fees	3,114	1,879
Pre-acquisition costs	6,195	4,011
Other deposits	3,143	3,734
	<u>\$ 104,542</u>	<u>\$ 88,134</u>

(1) See Note 12 *Leases* for additional information.

In the ordinary course of business, the Company enters into lot purchase agreements in order to procure lots for the construction of homes in the future. Pursuant to these lot purchase agreements, the Company generally will provide a deposit to the seller as consideration for the right, but not the obligation, to purchase lots at different times in the future, usually at predetermined prices. Depending on the circumstances of such lot purchase agreements, “Real estate not owned” may be recorded based on the application of different accounting provisions in accordance with ASC 810 or ASC 470-40. In applying these provisions, the Company regularly evaluates its land and lot purchase agreements.

Pursuant to ASC 810, when the Company enters into a purchase agreement to acquire land or lots from an entity and pays a non-refundable deposit, the Company has concluded that a variable interest entity (“VIE”), for which consolidation is required, may be created because it is deemed to have provided subordinated financial support that will absorb some or all of an entity’s expected losses if they occur. For each VIE, the Company assesses whether it is the primary beneficiary of the VIE and thus must consolidate the entity by first determining if it has the ability to control the activities of the VIE that most significantly impact its economic performance. Such activities include, but are not limited to, the ability to determine the budget and scope of land development work, if any; the ability to control financing decisions for the VIE; the ability to acquire additional land into the VIE or dispose of land in the VIE not under contract; and the ability to change or amend the existing purchase contract with the VIE. If the Company is determined not to control such activities, it is not considered the primary beneficiary of the VIE. If it does have the ability to control such activities, it will continue the analysis by determining if it is expected to absorb a potentially significant amount of the VIE’s losses or, if no party absorbs the majority of such losses, if it will benefit from potentially a significant amount of the VIE’s expected gain. If the Company determines that it is the primary beneficiary of the VIE, it will consolidate the VIE in its financial statements and reflect such assets as “Real estate not owned” and the related liabilities as “Liabilities related to real estate not owned.” At November 30, 2019 and May 31, 2019, no purchase contracts or investments in unconsolidated entities were determined to require consolidation under ASC 810.

Pursuant to ASC 470-40, if a buying entity participates in an arrangement in which it is economically compelled to purchase land, then the entity is required to consolidate such an arrangement. From time to time, the Company enters into arrangements in which it identifies lots that it desires to purchase, finds an investor to purchase the lots and then enters into option purchase agreements to acquire the lots in staged takedowns. In consideration for such options, the Company generally makes nonrefundable deposits. While the Company is generally not obligated to purchase the lots that are the subject of such agreements, it would forfeit the remaining deposits if the lots are not purchased. Although the Company is not obligated to purchase the lots under option unless it enters into a contract with specific performance obligations, if, at the reporting date, the Company believes that due to the terms of the purchase contracts it is compelled to purchase the lots under option, the Company will record “Real estate not owned” and the related liabilities as “Liabilities related to real estate not owned” in connection with such option purchase agreements. The Company has entered into one lot purchase agreement with an unaffiliated investor group and has accounted for it pursuant to ASC 470-40. At November 30, 2019 and May 31, 2019, the Company recorded real estate not owned of \$27.6 million and \$33.3 million, respectively, related to the lot purchase agreement accounted for pursuant to ASC 470-40.

Also, based on the provisions of ASC Subtopic 606-10, *Revenue From Contracts With Customers*, a seller may not recognize as a sale property it sells if an entity has an obligation or a right to repurchase lots and if the repurchase agreement is considered to be a financing arrangement. ASC 606 considers a repurchase option contract to be a financing

arrangement, in accordance with ASC 606-10-55-70, if the entity will repurchase the lots for an amount that is equal to or greater than the original selling price of the asset. Therefore, if the Company enters into lot purchase option agreements for land it has sold and determines that the repurchase agreement is considered to be a financing arrangement, the Company records the lots subject to such sale as “Real estate not owned” and the related liabilities, under option agreement, as “Liabilities related to real estate not owned.” At November 30, 2019 and May 31, 2019, the Company recorded real estate not owned of \$37.9 million and \$31.5 million, respectively, for the sale of lots because its repurchase agreements related to this real estate were considered to be financing arrangements. These option agreements contain no specific performance obligations.

See Note 12 for additional information on right-of-use assets.

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

Deferred financing fees included in other assets are comprised of costs incurred in connection with obtaining financing under the senior secured revolving credit facility. Deferred financing fees are amortized as interest over the terms of the related financing arrangement using the effective interest method. The Company incurred deferred financing fees of \$1.9 million during the six months ended November 30, 2019 primarily as a result of the amendment to the Company's senior secured revolving credit facility, as discussed below in Note 6. The Company did not incur any deferred financing fees during the six months ended November 30, 2018.

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

Note 5 — Investments in Unconsolidated Entities

The Company enters into land joint ventures from time to time as a means of accessing larger parcels of land and lot positions, managing its risk profile and leveraging its capital base. As of November 30, 2019, the Company had an equity investment in one land joint venture with an affiliate of certain of the beneficial owners of the Company's equity or their affiliates (individually and collectively, the “Investors”). The Company has a 49% limited partner interest in this joint venture, does not have a controlling interest in this unconsolidated entity, and has accounted for it under the equity method. The lot purchase agreement permits the Company to purchase finished lots owned by the land joint venture. Lot prices are generally negotiated prices that approximate fair value when the purchase contract is signed. The Company's share of the unconsolidated entity's earnings on the sale of lots to the Company is deferred until homes related to the lots purchased by the Company are delivered and title passes to a homebuyer. The partners generally share profits and losses in accordance with their ownership interests. As of November 30, 2019, the Company had recorded \$1.1 million for its investment in this unconsolidated entity in the unaudited condensed consolidated balance sheet. The Company has also entered into a services agreement with the joint venture to provide accounting and administrative services to the joint venture. The Company receives a monthly fee of \$6,000 for these services that is included in other income in the unaudited condensed consolidated statements of income. The Company is a party to a lot purchase agreement with the joint venture, which required a 10% deposit, and has no specific performance requirements for the Company. As of November 30, 2019, the total purchase price of lots remaining to be purchased under this agreement was approximately \$17.6 million. As of November 30, 2019, the joint venture had \$1.9 million of debt outstanding, which is non-recourse to the joint venture and to the Company. The loan was obtained to fund land development for one phase of the property. The Company provided the lender with a performance guarantee for the substantial completion of this phase of development. The guarantee of performance may include the payment of money for costs incurred during the completion of the development. In the event the Company pays money or performs any services pursuant to the guarantee, the joint venture has agreed to indemnify and reimburse the Company for any such costs incurred.

The Company offers residential mortgage services to its homebuyers and the public at large in Austin, Dallas, Houston, San Antonio, Charleston, Raleigh, Orlando, Phoenix, and Southwest Florida through an unconsolidated mortgage joint venture. The Company has an ownership interest of 49% in this mortgage joint venture. The Company's investment in this mortgage joint venture is accounted for under the equity method. The debt of the mortgage joint venture is non-recourse to the Company.

Summarized unaudited financial information related to unconsolidated entities that are accounted for using the equity method as of November 30, 2019 and May 31, 2019 and for the three and six months ended November 30, 2019 and 2018 was as follows (in thousands):

	November 30, 2019	May 31, 2019
Assets:		
Cash	\$ 3,288	\$ 6,274
Mortgage notes receivable	27,081	48,049
Real estate	7,101	9,337
Other	606	650
Total assets	<u>\$ 38,076</u>	<u>\$ 64,310</u>
Liabilities and equity:		
Liabilities:		
Accounts payable and other accruals	\$ 4,399	\$ 5,859
Notes payable ⁽¹⁾	27,761	47,819
Total liabilities	<u>32,160</u>	<u>53,678</u>
Equity	5,916	10,632
Total liabilities and equity	<u>\$ 38,076</u>	<u>\$ 64,310</u>

(1) The notes payable balance at November 30, 2019 is comprised of \$25.9 million outstanding on two warehouse lines and \$1.9 million of secured debt that is non-recourse to the Company. The notes payable balance at May 31, 2019 is comprised of \$46.0 million outstanding on two warehouse lines and \$1.8 million of secured debt that is non-recourse to the Company.

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
Revenues:				
Lot sales	\$ 2,653	\$ 2,850	\$ 5,631	\$ 5,681
Financial services	4,108	2,299	7,748	4,738
Total revenues	<u>6,761</u>	<u>5,149</u>	<u>13,379</u>	<u>10,419</u>
Gross profit	<u>3,195</u>	<u>2,012</u>	<u>6,081</u>	<u>4,068</u>
General and administrative expenses:				
Lot sales	—	4	—	10
Financial services	707	412	1,382	832
Total general and administrative expenses	<u>707</u>	<u>416</u>	<u>1,382</u>	<u>842</u>
Net earnings	<u>\$ 2,488</u>	<u>\$ 1,596</u>	<u>\$ 4,699</u>	<u>\$ 3,226</u>

Note 6 — Debt

Debt at November 30, 2019 and May 31, 2019 consisted of the following (in thousands):

	November 30, 2019	May 31, 2019
9.875% Notes ⁽¹⁾	\$ 248,664	\$ 248,268
6.750% Notes ⁽²⁾	246,517	246,173
Senior secured revolving credit facility	165,357	20,427
	<u>\$ 660,538</u>	<u>\$ 514,868</u>

(1) Net of \$4.7 million and \$5.0 million of unamortized deferred financing costs and \$1.7 million and \$1.8 million of unamortized discount as of November 30, 2019 and May 31, 2019, respectively.

(2) Net of \$3.5 million and \$3.8 million of unamortized deferred financing costs as of November 30, 2019 and May 31, 2019, respectively.

The 9.875% Notes

On March 27, 2019, the Company issued \$255.0 million principal amount of 9.875% Senior Notes due 2027 (the “9.875% Notes”) in a private offering pursuant to Rule 144A and Regulation S under the Securities Act of 1933, as amended. The 9.875% Notes were issued at a price of 99.301% of the principal amount to yield 10.000%.

The 9.875% Notes mature on April 1, 2027. Interest is payable on the 9.875% Notes on April 1 and October 1 of each year. The 9.875% Notes are senior, unsecured obligations of the Company and rank equally in right of payment to all of the Company’s existing and future senior debt and senior in right of payment to the Company’s existing and future subordinated debt. The 9.875% Notes are effectively subordinated to any of the Company’s existing and future secured debt, including the Company’s senior secured revolving credit facility, to the extent of the value of the assets securing such debt. The obligations under the 9.875% Notes are jointly and severally guaranteed by each Restricted Subsidiary, as defined, other than certain Restricted Subsidiaries that have assets with a book value of less than \$2.0 million. All of the Company’s subsidiaries are Restricted Subsidiaries with respect to the 9.875% Notes, with the exception of AW Mortgage Holdings L.L.C., which has been designated an Unrestricted Subsidiary pursuant to the indenture governing the 9.875% Notes.

The indenture governing the 9.875% Notes gives the Company the option to redeem the 9.875% Notes at any time or from time to time, in whole or in part, (a) until April 1, 2025, at certain redemption prices set forth in the indenture governing the 9.875% Notes together with accrued and unpaid interest thereon, if any, to and excluding the redemption date, and (b) on or after April 1, 2025, at 100% of the principal amount to be redeemed, together with accrued and unpaid interest thereon, if any, to and excluding the redemption date.

The indenture governing the 9.875% Notes contains a number of covenants, including covenants relating to the following:

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

As of November 30, 2019, the Company was in compliance with the covenants in the indenture governing the 9.875% Notes.

The 6.750% Notes

On August 8, 2017, the Company issued \$250 million principal amount of 6.750% Senior Notes due 2025 (the “6.750% Notes”) in a private offering pursuant to Rule 144A and Regulation S under the Securities Act of 1933, as amended. The 6.750% Notes were issued at a price of 100.00% of the principal amount to yield 6.750%.

The 6.750% Notes mature on August 1, 2025. Interest is payable on February 1 and August 1 of each year, commencing February 1, 2018. The 6.750% Notes are senior, unsecured obligations of the Company and rank equally in right of payment to all of the Company's existing and future senior debt and senior in right of payment to all the Company's existing and future subordinated debt. The 6.750% Notes are effectively subordinated to any of the Company's existing and future secured debt, including the senior secured revolving credit facility, to the extent of the value of the assets securing such debt. The obligations under the 6.750% Notes are jointly and severally guaranteed by each Restricted Subsidiary, as defined, other than certain Restricted Subsidiaries that have assets with a book value of less than \$2.0 million. All of the Company's subsidiaries are Restricted Subsidiaries with respect to the 6.750% Notes, with the exception of AW Mortgage Holdings L.L.C., which has been designated an Unrestricted Subsidiary pursuant to the indenture governing the 6.750% Notes.

The Company has the option to redeem the 6.750% Notes at any time or from time to time, in whole or in part, (a) until August 1, 2020, at a redemption price equal to 100% of their principal amount, together with accrued and unpaid interest thereon, if any, to and excluding the redemption date, plus an applicable premium as defined in the indenture governing the 6.750% Notes, (b) on or after August 1, 2020, at certain redemption prices set forth in the indenture governing the 6.750% Notes together with accrued and unpaid interest thereon, if any, to and excluding the redemption date, and (c) on or after August 1, 2023, at 100% of the principal amount to be redeemed, together with accrued and unpaid interest thereon, if any, to and excluding the redemption date.

The indenture governing the 6.750% Notes contains a number of covenants, including covenants relating to the following:

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

As of November 30, 2019, the Company was in compliance with the covenants in the indenture governing the 6.750% Notes.

Senior Secured Revolving Credit Facility

On August 28, 2019, the Company amended its senior secured revolving credit facility by entering into its Second Amendment to the Fifth Amended and Restated Credit Agreement (as amended, the "Restated Revolver"), providing for, among other things, (i) an aggregate revolving loan commitment of up to \$350.0 million with up to \$50.0 million available for the issuance of letters of credit and a \$20.0 million swingline facility, and with an accordion feature to permit the size of the facility to be increased in the future up to \$420.0 million (dependent upon Company needs and available lender commitments), (ii) a maturity date of August 28, 2023, and (iii) modification of certain covenants and restating the agreement to reflect such changes. The Restated Revolver limits the principal amount of the aggregate commitment available at any time to the amount that is permitted by the indentures governing the Company's 6.750% Notes and 9.875% Notes, which is 30% of Consolidated Tangible Assets, as defined therein.

Interest accrues on borrowings under the Restated Revolver at the London Interbank Offered Rate (LIBOR) plus an applicable margin that ranges from 275 to 335 basis points. Letters of credit may be issued under the Restated Revolver at a rate of 100 basis points if secured by cash, or at a rate of 275 to 335 basis points if not secured by cash. The Restated Revolver has a maturity date of August 28, 2023, subject to an extension in accordance with the terms set forth therein. The Restated Revolver is secured by a continuing first priority security interest in the real property of certain operating divisions selected by the Company for inclusion in the borrowing base, and the personal property of the Company and its subsidiaries affixed to, placed upon, used in connection with, arising from or appropriated for use on the pledged real property and the continuing guarantee of substantially all of its subsidiaries. The Company may pledge additional collateral as needed to increase the borrowing base consistent with the maximum availability under the Restated Revolver.

The Restated Revolver contains the following material financial covenants:

- A minimum level of Tangible Net Worth;

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

Availability under the Restated Revolver is based upon a borrowing base formula. The Restated Revolver contains other affirmative and negative covenants in addition to the financial covenants noted above. The Restated Revolver permits sales and transfers of ownership interests in the Company so long as no change of control, as defined in the Restated Revolver, occurs and permits certain tax distributions to Members and permits certain other distributions to Members if certain Leverage Ratio and other conditions are met. As of November 30, 2019, the Company was in compliance with the covenants in the Restated Revolver.

At November 30, 2019, there was \$165.4 million outstanding under the Restated Revolver and \$3.0 million of letters of credit outstanding. As of November 30, 2019, the Company had available additional borrowing capacity of \$86.6 million under the Restated Revolver based on outstanding borrowings on the Restated Revolver, outstanding letters of credit, the value of collateral pledged to secure the facility, and the borrowing base formula.

Note 7 — Other Liabilities

Other liabilities at November 30, 2019 and May 31, 2019 consisted of the following (in thousands):

	November 30, 2019	May 31, 2019
Liabilities related to real estate not owned ⁽¹⁾	\$ 46,014	\$ 41,467
Salaries, bonuses and benefits	17,175	27,786
Lease liabilities ⁽²⁾	16,189	—
Accrued interest	10,787	11,120
Warranty accruals	9,658	11,932
Accrued long-term compensation	7,906	8,245
Accrued real estate taxes	4,631	2,912
Other	13,876	16,530
	<u>\$ 126,236</u>	<u>\$ 119,992</u>

(1) Net of deposits of \$19.4 million and \$23.3 million as of November 30, 2019 and May 31, 2019, respectively.

(2) See Note 12 *Leases* for additional information.

Note 8 — Members' Equity, Amended Regulations, and Ownership

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

In September 2018, Little Shots purchased 3,172 Class B Units and other Members purchased 428 Class B Units from another Class B Unit holder.

At November 30, 2019, there were 20,628,729 membership interests outstanding, comprised as follows:

	Membership Interests	Ownership percentage	Percentage of membership class
Little Shots Nevada L.L.C.			
Class A	8,027,200	38.91%	100.00%
Class B	1,922,151	9.32%	97.43%
Class C	8,167,244	39.59%	76.84%
Total Little Shots Nevada L.L.C.	18,116,595	87.82%	
Various Holders			
Class B	50,649	0.25%	2.57%
Class C	2,461,485	11.93%	23.16%
	<u>20,628,729</u>	<u>100.00%</u>	

Note 9 — Transactions with Related Parties

Services agreement

The Company is a party to a services agreement with the Investors that provides the Company with a license, as well as development and support, for certain of the Company's computer systems and administrative services. The Company pays a fee of \$800 per home closing quarterly, in arrears, for these services, which is included in selling, general and administrative expenses in the unaudited condensed consolidated statements of income. The Company incurred fees of \$0.9 million and \$1.7 million during the three and six months ended November 30, 2019, respectively, and \$0.7 million and \$1.4 million during the three and six months ended November 30, 2018, respectively, under the services agreement. As of November 30, 2019 and May 31, 2019, the balance due to the Investors under the terms of the service agreement was \$0.8 million and \$1.3 million, respectively, and was included in other liabilities in the unaudited condensed consolidated balance sheets.

Lease

The Company is a party to a lease as a lessee with the Investors to rent approximately 8,500 square feet of commercial space in Dallas, Texas. The Company has 37 months remaining on the lease as of November 30, 2019. Total minimum lease payments due under the lease were \$0.3 million and \$0.2 million as of November 30, 2019 and 2018, respectively.

Lot purchase agreements

The Company is a party to six lot purchase agreements with the Investors. A deposit ranging from 10% to 20% was required under each of the purchase agreements, and there are no specific performance requirements for the Company. We are required to record one of these lot purchase agreements as real estate not owned in the unaudited condensed consolidated balance sheets. As of November 30, 2019, the total purchase price of lots remaining to be purchased under such agreements was approximately \$25.4 million.

Joint venture

The Company is a party to a land joint venture with the Investors, which is accounted for under the equity method. The Company has an equity investment of less than 50% in the joint venture and does not have a controlling interest in the unconsolidated entity. Also, the Company is a party to a lot purchase agreement with the joint venture to purchase 130 lots. A 10% deposit was required under the purchase agreement and there are no specific performance requirements for the Company. As of November 30, 2019, the total purchase price of lots remaining to be purchased was \$17.6 million. As of November 30, 2019, the joint venture had \$1.9 million of debt outstanding, which is non-recourse to the joint venture and to the Company. The loan was obtained to fund land development for one phase of the property. The Company provided the lender with a performance guarantee for the substantial completion of this phase of development. The guarantee of performance may include the payment of money for costs incurred during the completion of the development.

In the event the Company pays money or performs any services pursuant to the guarantee, the joint venture has agreed to indemnify and reimburse the Company for any such costs incurred.

Note 10 — Long-Term Incentive Plan

In July 2012, the Board of Directors adopted the Ashton Woods USA L.L.C. 2013 Performance Share Plan (the “2013 Plan”), a long-term incentive compensation program designed to align the interests of the Company and its executives by enabling key employees to participate in the Company’s future growth. In July 2013, the Board of Directors adopted the Amended and Restated Performance Share Plan (the “First Amended Plan”), and in July 2016, the Board of Directors adopted the Second Amended and Restated Performance Share Plan, with an effective date of June 1, 2016 (the “Second Amended Plan”) (together with the 2013 Plan and the First Amended Plan, the “Plan”). The Plan provides for the grant to participants of full-value performance shares and appreciation-only performance shares, which are the equivalent of phantom equity awards. Full-value performance shares allow the participant to receive a cash payment equal to the total value of the performance share on the designated date of payment. Appreciation-only performance shares allow the participant to receive a cash payment equal to the increase in value of the performance share measured from the date of grant to the designated date of payment. In each July of 2013 through 2019, the Board of Directors awarded outstanding performance shares to the Company’s executive officers, and certain officers and members of the corporate and operating division senior management teams.

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

The following table represents a rollforward of the outstanding performance shares for the six months ended November 30, 2019:

	Full-value shares	Appreciation- only shares	Total shares
Outstanding performance shares as of May 31, 2019	232,159	618,064	850,223
Performance shares awarded during the period	82,807	165,614	248,421
Shares forfeited during the period	—	—	—
Fully vested performance shares paid	(71,050)	(71,190)	(142,240)
Total outstanding performance shares as of November 30, 2019	243,916	712,488	956,404
Total vested performance shares as of November 30, 2019	98,022	420,703	518,725

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

The total number of performance shares vested as of November 30, 2019 and May 31, 2019 was 518,725 and 600,038, respectively. The Company recorded \$1.5 million and \$2.5 million for the three and six months ended November 30, 2019, respectively, and \$0.4 million and \$1.2 million for the three and six months ended November 30, 2018, respectively, in compensation expense associated with the full-value and appreciation-only performance shares. For the six months ended November 30, 2019 and 2018, \$2.9 million (142,240 units) and \$2.5 million (135,933 units), respectively, of

vested performance shares were paid out to employees. As of November 30, 2019 and May 31, 2019, the Company's liability for the performance shares was \$7.9 million and \$8.2 million, respectively, which is recorded in other liabilities in the unaudited condensed consolidated balance sheets.

Note 11 — Fair Value Disclosures

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

- **Level 1:** Valuation is based on quoted prices in active markets for identical assets and liabilities.
- **Level 2:** Valuation is determined from quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar instruments in markets that are not active, or by model-based techniques in which all significant inputs are observable in the market.
- **Level 3:** Valuation is derived from model-based techniques in which at least one significant input is unobservable and based on the Company's own estimates about the assumptions that market participants would use to value the asset or liability.

The carrying amounts of cash and cash equivalents, restricted cash, accounts receivable, accounts payable, customer deposits, notes payable, and the Restated Revolver, as reported in the accompanying unaudited condensed consolidated balance sheets, approximate their fair values due to their short-term maturity or floating interest rate terms, as applicable. The factors considered in determining fair values of the Company's communities when necessary under ASC 360 are described in the discussion of the Company's inventory impairment analysis (see Note 1), and are classified as Level 2 or Level 3 valuations. The following table summarizes ranges for the significant quantitative unobservable inputs we utilized in our fair value measurements with respect to the inventory impairments recorded during the periods presented:

Unobservable Inputs:	Six months ended November 30, 2019
Average selling price	\$300,000 - \$667,000
Annual discount rate	12%

The following table presents the carrying amounts and estimated fair values of the Company's 9.875% Notes and 6.750% Notes at November 30, 2019 and May 31, 2019:

	Fair Value Hierarchy	November 30, 2019		May 31, 2019	
		Carrying Amount	Fair Value	Carrying Amount	Fair Value
(in thousands)					
Liabilities:					
9.875% Notes	Level 2	\$ 248,664	\$ 286,569	\$ 248,268	\$ 262,650
6.750% Notes	Level 2	246,517	253,450	246,173	233,750
		<u>\$ 495,181</u>	<u>\$ 540,019</u>	<u>\$ 494,441</u>	<u>\$ 496,400</u>

The Company's 9.875% Notes and 6.750% Notes are recorded at their carrying values in the unaudited condensed consolidated balance sheets, which may differ from their respective fair values. The carrying values of the Company's 9.875% Notes and 6.750% Notes reflect their face amount, adjusted for any unamortized debt issuance costs and discount. The fair values of the 9.875% Notes and 6.750% Notes are derived from quoted market prices by independent dealers (Level 2).

Note 12 — Commitments and Contingencies

The Company is involved in lawsuits and other contingencies in the ordinary course of business. The amounts demanded by the claimants in these lawsuits and claims may vary widely, with large demands made in certain cases, which are disputed and aggressively defended by the Company. Management believes that, while the ultimate outcome of these ordinary course matters cannot be predicted with certainty, the ultimate liability, if any, net of anticipated

recoveries including from insurance, will not have a material adverse effect on the Company's financial condition, results of operations, or cash flows.

In addition, on June 27, 2016, FCC Marsh, LLC (the "Seller") filed a complaint against Ashton Tampa Residential, LLC, a wholly owned subsidiary of Ashton Woods USA L.L.C. ("Ashton Woods USA"), in the Circuit Court for Collier County, Florida, alleging that the Company breached a lot purchase agreement that provided the Seller with a specific performance right against the Company, subject to certain conditions, by allegedly failing to close on certain lot purchases. The Seller dismissed its claim for specific performance, and seeks declaratory relief and damages. The Company filed a counterclaim seeking declaratory relief, return of the earnest money deposit, foreclosure of the mortgage that secures that deposit, and damages for the Seller's breach of a lease agreement between the parties. On April 5, 2019, the Seller filed a motion to amend its complaint to add Ashton Woods USA as a defendant, and to assert a tortious interference claim against Ashton Woods USA, which motion was granted by the court. Subsequently, on April 30, 2019, the Seller filed a separate complaint against Ashton Woods USA in the Circuit Court for Collier County, Florida asserting the identical tortious interference claim. Ashton Woods USA filed a motion to dismiss the complaint, which was then voluntarily dismissed by the Seller. At a hearing on September 16, 2019, the court granted the Seller's motion for summary judgment on the Company's claim for declaratory relief with respect to the \$1.4 million earnest money deposit and ordered that those funds be released to the Seller. In July 2019, FCC Marsh submitted an expert report in which they claim \$20.3 million in damages. The Company vigorously denies that it caused FCC Marsh any damages. In addition, in October 2019, the court entered an order requiring the parties to mediate the lawsuit, which is currently scheduled to occur in January 2020. The parties have filed cross motions for partial summary judgment, and the court has entered an order that currently sets the lawsuit on the March 30, 2020 trial docket. While it is premature to predict the ultimate outcome of these proceedings, the Company intends to vigorously defend the lawsuit and pursue its claim against the Seller.

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

In the normal course of business, the Company provides letters of credit and surety bonds to third parties to secure performance and provide deposits under various contracts and commitments. At November 30, 2019 and May 31, 2019, the Company had letters of credit outstanding of \$3.0 million and \$4.3 million, respectively, and surety bonds outstanding of \$65.9 million and \$56.6 million, respectively. As of November 30, 2019, the Company had \$42.0 million of unused letter of credit capacity under the Restated Revolver.

The Company enters into various option purchase agreements to acquire land. In connection with such agreements, as of November 30, 2019, the Company has made nonrefundable deposits of \$145.8 million, which includes \$19.4 million of nonrefundable deposits related to purchase and option agreements recorded under ASC 606 or ASC 470-40 (See Note 4). The Company would forfeit the remaining deposits if the lots are not purchased. The total purchase price of lots remaining to be purchased under option agreements with nonrefundable deposits was approximately \$1.1 billion as of November 30, 2019.

Leases

The Company leases office space and equipment under various operating leases with varying commencement dates and renewal options for use in our operations. We recognize lease expense for these leases on a straight-line basis over the lease term and combine lease and non-lease components for all leases. Right-of-use assets and Lease liabilities are recorded on the unaudited condensed consolidated balance sheet for all leases with an expected term of at least one year. Some leases include one or more options to renew. The exercise of lease renewal options is generally at our discretion. The depreciable lives of right-of-use assets and leasehold improvements are limited to the expected lease term. Our lease agreements do not contain any residual value guarantees or material restrictive covenants.

Right-of-use assets are classified within other assets on the unaudited condensed consolidated balance sheets, while Lease liabilities are classified within other liabilities on the unaudited condensed consolidated balance sheets. Right-of-use assets and Lease liabilities were \$15.2 million and \$16.2 million at November 30, 2019, respectively. During the six months ended November 30, 2019, there was \$24.8 thousand of additions to the right-of-use assets under operating leases. Payments on Lease liabilities during the six months ended November 30, 2019 totaled \$2.0 million.

Lease expense includes costs for leases with terms in excess of one year as well as short-term leases with terms of less than one year. For the six months ended November 30, 2019 and 2018 our total lease expense approximated \$2.9 million and \$2.4 million, respectively, inclusive of short-term lease costs. Sublease income, short-term lease costs, and variable lease costs are not material to the unaudited condensed consolidated financial statements.

The future minimum lease payments required under our leases as of November 30, 2019 are as follows (in thousands):

Year ending May 31, 2020 ^(a)	\$ 2,037
Year ending May 31, 2021	4,481
Year ending May 31, 2022	4,131
Year ending May 31, 2023	3,463
Year ending May 31, 2024	2,847
Thereafter	4,355
Total future minimum lease payments^(b)	21,314
Less: Interest ^{(c)(d)}	5,125
Total future minimum lease payments less interest^(d)	\$ 16,189

- (a) Remaining payments are for the six months ending May 31, 2020.
(b) Lease payments include options to extend lease terms that are reasonably certain of being exercised.
(c) Our leases do not provide a readily determinable implicit rate. Therefore, we estimate our discount rate for such leases to determine the present value of lease payments at the lease commencement date.
(d) The weighted average lease term and weighted average discount rate used in calculating our Lease liabilities were 5.2 years and 8.2%, respectively, at November 30, 2019.

Note 13 — Information on Segments

The Company's homebuilding reportable segments are as follows:

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

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

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
Revenues:				
Homebuilding:				
East	\$ 179,214	\$ 190,800	\$ 365,842	\$ 383,136
Central	196,760	145,540	373,567	309,008
Total revenues	\$ 375,974	\$ 336,340	\$ 739,409	\$ 692,144
Gross profit⁽¹⁾:				
Homebuilding:				
East	\$ 28,448	\$ 31,876	\$ 54,471	\$ 65,364
Central	38,832	26,342	71,069	58,096
Total gross profit	\$ 67,280	\$ 58,218	\$ 125,540	\$ 123,460

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
Depreciation and amortization:				
East	\$ 1,146	\$ 1,386	\$ 2,220	\$ 2,647
Central	1,488	1,254	2,748	2,664
Total depreciation and amortization	<u>\$ 2,634</u>	<u>\$ 2,640</u>	<u>\$ 4,968</u>	<u>\$ 5,311</u>
Equity in earnings of unconsolidated entities:				
East	\$ 93	\$ (2)	\$ 188	\$ (2)
Central	990	659	1,863	1,383
Total equity in earnings of unconsolidated entities	<u>\$ 1,083</u>	<u>\$ 657</u>	<u>\$ 2,051</u>	<u>\$ 1,381</u>
Net income:				
East	\$ 2,148	\$ 5,638	\$ 788	\$ 10,791
Central	11,863	4,807	17,184	13,279
	14,011	10,445	17,972	24,070
Other ⁽²⁾	(1,072)	(1,777)	(1,870)	(3,521)
Total net income	<u>\$ 12,939</u>	<u>\$ 8,668</u>	<u>\$ 16,102</u>	<u>\$ 20,549</u>

- (1) Includes inventory impairments on homes totaling \$37.0 thousand and \$379.0 thousand for the east segment during the three and six months ended November 30, 2019, respectively, and \$41.0 thousand for the central segment during the six months ended November 30, 2019. There were no impairments in the central segment during the three months ended November 30, 2019. There were no impairments in the central segment during the three and six months ended November 30, 2018. There were \$1.3 million and \$0.6 million of impairments in the east segment and central segment during the six months ended November 30, 2018, respectively.
- (2) "Other" primarily consists of interest directly expensed and a loss from the early extinguishment of debt.

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

	November 30, 2019	May 31, 2019
Assets:		
Homebuilding:		
East	\$ 671,620	\$ 607,778
Central	610,414	513,553
	<u>1,282,034</u>	<u>1,121,331</u>
Other ⁽¹⁾	11,815	8,985
Total assets	<u>\$ 1,293,849</u>	<u>\$ 1,130,316</u>

- (1) "Other" is comprised of cash, restricted cash, and corporate assets.

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

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
Additions to property and equipment:				
Homebuilding:				
East	\$ 1,016	\$ 1,342	\$ 1,807	\$ 2,200
Central	974	1,020	2,463	1,980
	<u>1,990</u>	<u>2,362</u>	<u>4,270</u>	<u>4,180</u>
Other ⁽¹⁾	216	—	216	—
Total additions to property and equipment	\$ 2,206	\$ 2,362	\$ 4,486	\$ 4,180

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

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

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

Forward-Looking Statements

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

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

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

- Reversal of homebuilding recovery or decline in economic conditions;
- Fluctuations in mortgage interest rates and the availability of mortgage financing;
- The availability of high quality undeveloped land and improved lots at suitable prices;
- The volatility of the capital markets and the banking industry;
- An ownership change, which could have unfavorable implications for our debt instruments;
- The availability of qualified employees, skilled labor, qualified subcontractors, and raw materials;
- The competitive nature of the homebuilding industry;
- Deterioration of the economic climate either nationally or in the regions in which we operate, which could impact growth and expansion opportunities, impact the price of labor and materials, impact the value of our inventory, impact inflation, consumer confidence, and consumer preferences;
- Government regulatory and other actions, which could affect tax laws, including laws designed to incentivize home ownership, and could result in delays or increased costs in obtaining necessary permits and complying with environmental laws;
- Timing of permits and other regulatory approvals;
- Our substantial indebtedness and our ability to comply with the related financial and other covenants and our ability to obtain replacement financing as these instruments mature;
- The cost and availability of insurance and the level of warranty claims;
- Cybersecurity attacks, breaches, and/or threats, and related exposures;
- Judgments or other costs and exposure with respect to litigation and claims;
- Changes in accounting guidelines or our interpretation of those guidelines;
- Adverse weather conditions and acts of war or terror; and
- Other factors, including those discussed elsewhere in our annual report on Form 10-K for the fiscal year ended May 31, 2019, over which the Company has little or no control.

Overview

We design, build, and market detached and attached single-family homes in six states under the Ashton Woods Homes and Starlight Homes brand names. The Company offers entry-level, move-up, and multi-move-up homes under the Ashton Woods Homes brand name, and offers entry-level homes under the Starlight Homes brand name. Our Ashton Woods communities are created to deliver design and personalization for our homebuyers through collaboration and expertise. Our Ashton Woods sales and marketing strategy leverages our national brand while allowing our operating divisions to customize execution to meet the needs and preferences of our local markets. While Ashton Woods' value proposition is grounded in design and personalization, Starlight is focused on delivering more affordable homes. Our strategy in approaching the Starlight market is primarily to convert renters into first-time homebuyers by offering affordable, purely speculative inventory, that includes attractive features.

Presented below are certain operating and other data based on buyer profile:

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
Net new home orders (units):				
Entry-Level - Starlight Homes	514	232	1,098	459
Entry-Level - Ashton Woods	211	96	434	271
Move-up - Ashton Woods	396	310	851	705
Multi-Move-Up - Ashton Woods	107	78	204	157
Company Total	1,228	716	2,587	1,592

Homes closed (units):				
Entry-Level - Starlight Homes	435	254	893	513
Entry-Level - Ashton Woods	148	150	283	264
Move-up - Ashton Woods	386	386	728	736
Multi-Move-Up - Ashton Woods	108	110	215	272
Company Total	1,077	900	2,119	1,785

	As of November 30,	
	2019	2018
Backlog (units) at end of period:		
Entry-Level - Starlight Homes	527	218
Entry-Level - Ashton Woods	359	252
Move-up - Ashton Woods	707	624
Multi-Move-Up - Ashton Woods	183	240
Company Total	1,776	1,334

	As of November 30,	
	2019	2018
Active communities:		
Entry-Level - Starlight Homes	28	20
Entry-Level - Ashton Woods	26	12
Move-up - Ashton Woods	59	68
Multi-Move-Up - Ashton Woods	22	26
Company Total	135	126

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
Average monthly sales per average active community: ⁽¹⁾				
Entry-Level - Starlight Homes	6.6	4.3	6.8	4.4
Entry-Level - Ashton Woods	3.1	2.6	3.6	3.8
Move-up - Ashton Woods	2.1	1.4	2.2	1.6
Multi-Move-Up - Ashton Woods	1.7	1.0	1.5	1.0
Company Average	3.1	1.9	3.2	2.1

(1) Average active community for the three months ended November 30 is calculated by averaging the active community counts at November 30 and August 31. For the six months ended November 30, the average active community is calculated by averaging the active community counts at November 30 and May 31.

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
Average sales price per home closed (in thousands):				
Entry-Level - Starlight Homes	\$ 220	\$ 216	\$ 219	\$ 214
Entry-Level - Ashton Woods	\$ 334	\$ 302	\$ 284	\$ 303
Move-up - Ashton Woods	\$ 410	\$ 404	\$ 431	\$ 407
Multi-Move-Up - Ashton Woods	\$ 672	\$ 732	\$ 699	\$ 746
Company Average	\$ 349	\$ 374	\$ 349	\$ 388

During the six months ended November 30, 2019, we closed 2,119 homes. Of those closings, 1,802 (85%) were single-family detached product, while the remaining 317 (15%) of the homes closed were single-family attached product.

During the twelve months ended November 30, 2019, the Company added 67 new active communities, while closing out 58 communities. Of the 67 active communities added during the twelve months ended November 30, 2019, 16 (24%) are considered to be entry-level Starlight Homes, 13 (19%) are considered to be entry-level Ashton Woods, 28 (42%) are considered to be move-up Ashton Woods, and 10 (15%) are considered to be multi-move-up Ashton Woods.

Wholesale home sales within our Starlight Homes brand are included in consolidated net new home orders, homes closed, and backlog at end of period, as discussed in Note 1(j). Presented below is certain data for our wholesale home sales:

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
Wholesale (units): ⁽¹⁾				
Net new home orders	155	9	316	9
Homes closed	59	—	83	—
Backlog at end of period	262	9	262	9

(1) All activity for the six months ended November 30, 2019 was in the East segment.

Results of operations

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

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
Revenues:	(in thousands)			
Home sales	\$ 375,974	\$ 336,340	\$ 739,409	\$ 692,144
Land sales	5,970	2,239	5,970	2,314
Financial services and other revenues	12,651	1,253	14,979	2,750
	<u>\$ 394,595</u>	<u>\$ 339,832</u>	<u>\$ 760,358</u>	<u>\$ 697,208</u>
Gross profit (loss):				
Home sales	\$ 67,280	\$ 58,218	\$ 125,540	\$ 121,562
Land sales	1,469	276	1,441	(547)
Financial services and other revenues	2,261	1,253	4,589	2,750
	<u>\$ 71,010</u>	<u>\$ 59,747</u>	<u>\$ 131,570</u>	<u>\$ 123,765</u>
Selling, general and administrative	\$ 53,355	\$ 47,567	\$ 107,177	\$ 95,729
Net income ⁽¹⁾	\$ 12,939	\$ 8,668	\$ 16,102	\$ 20,549

- (1) Because we are structured as a limited liability company, income tax obligations are paid by our Members and are not borne by us. As a limited liability company, we periodically make tax distributions to our Members. The Company made tax distributions of \$8.6 million and \$19.4 million during the six months ended November 30, 2019 and 2018, respectively.

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
Supplemental data:	(\$ in thousands)			
Active communities at end of period	135	126	135	126
Net new home orders (in units)	1,228	716	2,587	1,592
Homes closed (in units) ⁽¹⁾	1,077	900	2,119	1,785
Average sales price per home closed	\$ 349	\$ 374	\$ 349	\$ 388
Backlog at end of period (in units)	1,776	1,334	1,776	1,334
Sales value of backlog at end of period	\$ 654,928	\$ 602,981	\$ 654,928	\$ 602,981
Home gross margin ⁽²⁾	17.9%	17.3%	17.0%	17.6%
Adjusted home gross margin ⁽³⁾	20.2%	19.3%	19.4%	19.7%
Ratio of selling, general and administrative expenses to home sales revenue	14.2%	14.1%	14.5%	13.8%
Interest incurred ⁽⁴⁾	\$ 13,471	\$ 11,051	\$ 26,434	\$ 21,372
EBITDA ⁽⁵⁾	\$ 27,227	\$ 19,693	\$ 44,261	\$ 42,883
EBITDA margin ⁽⁵⁾	6.9%	5.8%	5.8%	6.2%
Total debt to total capitalization	62.9%	63.7%	62.9%	63.7%
Total net debt to net capitalization	62.9%	63.7%	62.9%	63.7%
Cancellation rate (as a percentage of gross sales) ⁽⁶⁾	17.3%	28.2%	18.9%	26.2%

- (1) A home is included in “homes closed” when title to and possession of the property is transferred to the buyer. Revenues and cost of sales for a home are recognized at the time of the closing of a sale, when title to and possession of the property are transferred to the buyer.

- (2) Home gross margin is defined as the difference between home sales revenues and cost of sales—homes, expressed as a percentage of home sales revenues. Cost of sales—homes includes the land costs, home construction costs, indirect costs

of construction, previously capitalized interest, a reserve for warranty expense, architecture fee amortization, impairment charges, closing costs, and pre-acquisition costs related to real estate purchases that are no longer probable.

- (3) Adjusted home gross margin is not a financial measure under GAAP and should not be considered an alternative to home gross margin determined in accordance with GAAP as an indicator of operating performance. We use this measure to evaluate our performance against other companies in the homebuilding industry and believe it is also relevant and useful to investors. Adjusted home gross margin is home gross margin that is adjusted for inventory impairments and interest amortized to cost of sales. The following is a reconciliation of home gross margin, which is the most directly comparable GAAP measure, to adjusted home gross margin:

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
	(in thousands)			
Home sales revenues	\$ 375,974	\$ 336,340	\$ 739,409	\$ 692,144
Cost of sales homes	308,694	278,122	613,869	570,582
Home gross margin	67,280	58,218	125,540	121,562
Add: Inventory impairments - homes	37	—	420	1,898
Interest amortized to cost of sales	8,462	6,530	17,205	13,234
Adjusted home gross margin	<u>\$ 75,779</u>	<u>\$ 64,748</u>	<u>\$ 143,165</u>	<u>\$ 136,694</u>

- (4) Interest incurred for any period is the aggregate amount of interest that is capitalized or charged directly to general and administrative expenses during such period. The following table summarizes interest costs incurred, amortized to cost of sales, and expensed during the three and six months ended November 30, 2019 and 2018:

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
	(in thousands)			
Capitalized interest, beginning of period	\$ 20,484	\$ 15,545	\$ 19,040	\$ 13,824
Interest incurred	13,471	11,051	26,434	21,372
Interest amortized to cost of sales	(8,462)	(6,530)	(17,205)	(13,234)
Interest expensed	(3,170)	(1,817)	(5,946)	(3,713)
Capitalized interest, end of period	<u>\$ 22,323</u>	<u>\$ 18,249</u>	<u>\$ 22,323</u>	<u>\$ 18,249</u>

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

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

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
	(in thousands)			
Net income	\$ 12,939	\$ 8,668	\$ 16,102	\$ 20,549
Depreciation and amortization	2,656	2,678	5,008	5,387
Interest amortized to cost of sales	8,462	6,530	17,205	13,234
Interest expensed	3,170	1,817	5,946	3,713
EBITDA	<u>\$ 27,227</u>	<u>\$ 19,693</u>	<u>\$ 44,261</u>	<u>\$ 42,883</u>

- (6) The following table summarizes the cancellation rates (as a percentage of gross sales) by buyer profile for the three and six months ended November 30, 2019 and 2018:

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
Entry-Level - Starlight Homes	23.5%	42.9%	26.5%	43.3%
Entry-Level - Ashton Woods	13.9%	19.5%	11.8%	15.1%
Move-up - Ashton Woods	12.0%	17.1%	12.4%	14.5%
Multi-Move-Up - Ashton Woods	9.3%	20.4%	12.4%	22.7%
Consolidated	17.3%	28.2%	18.9%	26.2%

Results of operations - Segments

We have grouped our homebuilding operating divisions into two reportable segments, east and central. At November 30, 2019, our reportable homebuilding segments consisted of homebuilding operating divisions located in the following areas:

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

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

Net new home orders (units):

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
East	503	361	1,154	853
Central	725	355	1,433	739
Company total	1,228	716	2,587	1,592

Homes closed (units):

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
East	479	515	997	998
Central	598	385	1,122	787
Company total	1,077	900	2,119	1,785

Average sales price per home closed:

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
	(in thousands)			
East	\$ 374	\$ 370	\$ 367	\$ 384
Central	\$ 329	\$ 378	\$ 333	\$ 393
Company average	\$ 349	\$ 374	\$ 349	\$ 388

Backlog (units) at end of period:

	As of November 30,	
	2019	2018
East	713	769
Central	1,063	565
Company total	1,776	1,334

Sales value of backlog at end of period:

	As of November 30,	
	2019	2018
	(in thousands)	
East	\$ 271,546	\$ 361,158
Central	383,382	241,823
Company total	\$ 654,928	\$ 602,981

Active communities:

	As of November 30,	
	2019	2018
East	58	66
Central	77	60
Company total	135	126

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

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
	(in thousands)			
Homebuilding East:				
Home sales revenues	\$ 179,214	\$ 190,800	\$ 365,842	\$ 383,136
Cost of sales homes	150,766	158,924	311,371	317,772
Home gross margin	28,448	31,876	54,471	65,364
Add: Inventory impairments	37	—	379	1,323
Interest amortized to cost of sales	4,730	3,851	9,981	7,870
Adjusted home gross margin	\$ 33,215	\$ 35,727	\$ 64,831	\$ 74,557
Ratio of home gross margin to home sales revenues	15.9%	16.7%	14.9%	17.1%
Ratio of adjusted home gross margin to home sales revenues	18.5%	18.7%	17.7%	19.5%

	Three months ended November 30,		Six months ended November 30,	
	2019	2018	2019	2018
Homebuilding Central:	(in thousands)			
Home sales revenues	\$ 196,760	\$ 145,540	\$ 373,567	\$ 309,008
Cost of sales homes	157,928	119,198	302,498	250,912
Home gross margin	38,832	26,342	71,069	58,096
Add: Inventory impairments	—	—	41	574
Interest amortized to cost of sales	3,732	2,679	7,224	5,364
Adjusted home gross margin	\$ 42,564	\$ 29,021	\$ 78,334	\$ 64,034
Ratio of home gross margin to home sales revenues	19.7%	18.1%	19.0%	18.8%
Ratio of adjusted home gross margin to home sales revenues	21.6%	19.9%	21.0%	20.7%

Results of operations - Discussion

Three and Six Months Ended November 30, 2019 Compared to Three and Six Months Ended November 30, 2018

Home sales revenues - Consolidated

Home sales revenues increased by 11.8% (\$39.6 million) and 6.8% (\$47.3 million) for the three and six months ended November 30, 2019, to \$376.0 million and \$739.4 million, respectively, from \$336.3 million and \$692.1 million for the three and six months ended November 30, 2018, respectively. The increases in revenues for the three and six months ended November 30, 2019, as compared to the three and six months ended November 30, 2018, were due to an increase in the number of homes closed, partially offset by a decrease in the average sales price of homes closed.

The number of homes closed increased 19.7% (177) and 18.7% (334 homes) for the three and six months ended November 30, 2019, to 1,077 and 2,119, respectively, from 900 and 1,785 for the three and six months ended November 30, 2018, respectively. The average sales price of homes closed decreased 6.7% and 10.1% for the three and six months ended November 30, 2019, respectively, to an average of \$349,000 in both periods, from an average of \$374,000 and \$388,000 for the three and six months ended November 30, 2018, respectively. The decrease in the average sales price of homes closed on a consolidated basis for the three and six months ended November 30, 2019, compared to the three and six months ended November 30, 2018, was primarily due to our continued, planned shift in the mix of communities from which we had closings. We had a higher percentage of closings in entry-level communities, with generally lower average sales prices, during the three and six months ended November 30, 2019 compared to the three and six months ended November 30, 2018.

Home sales revenues - East segment

Home sales revenues for the east segment decreased by 6.1% (\$11.6 million) and 4.5% (\$17.3 million) for the three and six months ended November 30, 2019, to \$179.2 million and \$365.8 million, respectively, from \$190.8 million and \$383.1 million for the three and six months ended November 30, 2018, respectively. The decrease in revenues for the three months ended November 30, 2019, as compared to the three months ended November 30, 2018, was due to a decrease in the number of homes closed offset in part by an increase in the average sales price of homes closed. The decrease in revenues for the six months ended November 30, 2019, as compared to the six months ended November 30, 2018, was due to a decrease in the average sales price of homes closed and a decrease in the number of homes closed during the six months ended November 30, 2019.

The number of homes closed during the three months ended November 30, 2019 decreased 7.0% (36 homes) as compared to the three months ended November 30, 2018. The average sales price of homes closed increased 1.1% in the three months ended November 30, 2019 to an average of \$374,000 from an average of \$370,000 for the three months ended November 30, 2018. The decrease in the number of homes closed is primarily due to a 13% decrease in the average number of active communities for the three months ended November 30, 2019, as compared to the three months ended November 30, 2018. The increase in the average sales price of homes closed for the three months ended November 30, 2019, compared to the three months ended November 30, 2018, was primarily due to a higher percentage of multi-move-

up homes closed during the three months ended November 30, 2019, compared to the three months ended November 30, 2018. During the three months ended November 30, 2019, 89 (19%) of the homes closed were considered multi-move-up, compared to 73 (14%) for the three months ended November 30, 2018. Although the Company continues to reposition its communities to more lower-priced communities, the mix of homes closed can be impacted based on the timing of the close out and start-up of the communities.

The average sales price of homes closed decreased 4.4% in the six months ended November 30, 2019 to an average of \$367,000 from an average of \$384,000 for the six months ended November 30, 2018. The decrease in the average sales price of homes closed was primarily due to the continued, planned shift in the mix of communities from which we had closings to a higher percentage of closings in entry-level communities, with generally lower average sales prices. During the three and six months ended November 30, 2019, 266 (56%) and 571 (57%), respectively, of the homes closed were considered entry-level, compared to 264 (51%) and 513 (51%) for the three and six months ended November 30, 2018, respectively.

Home sales revenues - Central segment

Home sales revenues for the central segment increased by 35.2% (\$51.2 million) and 20.9% (\$64.6 million) for the three and six months ended November 30, 2019 to \$196.8 million and \$373.6 million, respectively, from \$145.5 million and \$309.0 million for the three and six months ended November 30, 2018, respectively. The increase in revenues for the three and six months ended November 30, 2019, as compared to the three and six months ended November 30, 2018, was due to an increase in the number of homes closed, partially offset by a decrease in the average sales price of homes closed.

The number of homes closed during the three and six months ended November 30, 2019 increased 55.3% (213 homes) and 42.6% (335 homes), respectively, as compared to the three and six months ended November 30, 2018. The average sales price of homes closed decreased 13.0% and 15.3% in the three and six months ended November 30, 2019 to an average of \$329,000 and \$333,000, respectively, from an average of \$378,000 and \$393,000 for the three and six months ended November 30, 2018, respectively. The decrease in the average sales price of homes closed during the three and six months ended November 30, 2019, compared to the three and six months ended November 30, 2018, was primarily due to the continued, planned shift in the mix of communities from which we had closings to a higher percentage of closings in entry-level communities, with generally lower average sales prices. During the three and six months ended November 30, 2019, 317 (53%) and 605 (54%), respectively, of the homes closed were considered entry-level, compared to 140 (36%) and 264 (34%) for the three and six months ended November 30, 2018, respectively.

Net new home orders, cancellations, and backlog - Consolidated

Net new home orders and backlog do not have a current effect on our revenues; however, both provide important information about our future revenues and business prospects. New home orders are converted to revenues at the time of the home closing. Net new home orders increased 71.5% (512 homes) and 62.5% (995 homes) for the three and six months ended November 30, 2019, respectively, compared to the three and six months ended November 30, 2018. The increase in net new home orders was driven by an increase in the number of active communities and an increase in the average sales pace per active community for the three and six months ended November 30, 2019, as compared to the three and six months ended November 30, 2018. Included in the net new home orders are 155 and 316 wholesale home sales to real estate investors for the three and six months ended November 30, 2019, respectively. These homes were sold under bulk sales agreements (see Note 1(j)). The Company had 9 wholesale home sales during the three and six months ended November 30, 2018.

The cancellation rates on our entry-level homes are typically higher than the cancellation rates on our move-up and multi-move-up homes. The most common reason for these cancellations is that the home buyer is not able to obtain financing. While the cancellation rates improved in all of our buyer profiles, the largest improvement was in the Starlight Homes entry-level buyer profile, which was positively impacted by the wholesale sales this quarter. Excluding wholesale sales, the cancellation rates on our Starlight Homes entry-level buyer profile were 30.6% and 33.6% for the three and six months ended November 30, 2019, respectively.

Our backlog consists of homes that are under purchase contracts that have not yet closed, or wholesale contracts for which the required deposits have been received. Backlog increased 33.1% from 1,334 homes in backlog at November 30, 2018 to 1,776 homes in backlog at November 30, 2019. The increase in backlog was a result of the Company selling 5,133 homes, which is 442 more homes than were closed (4,691 homes closed) during the twelve months ended November 30, 2019. The sales value of backlog at November 30, 2019 was \$654.9 million, an 8.6% increase from the

sales value of backlog at November 30, 2018 of \$603.0 million. The increase in the sales value of backlog is primarily due to the 33.1% increase in the number of homes in backlog, as discussed above, partially offset by a decrease in the average sales price of homes in backlog from \$452,000 at November 30, 2018 to \$369,000 at November 30, 2019. As discussed above, our communities have continued to shift to a higher percentage of entry-level communities. At November 30, 2019, 50% (886 homes) of backlog (including 262 wholesale home sales) were homes considered to be entry-level, compared to 35% (470 homes) at November 30, 2018, which include 9 wholesale home sales.

Net new home orders and backlog - East segment

Net new home orders in the east segment increased 39.3% (142 homes) and 35.3% (301 homes) during the three and six months ended November 30, 2019, respectively, compared to the three and six months ended November 30, 2018. The increase in net new home orders was largely driven by an increase in the average sales pace per active community for the three and six months ended November 30, 2019, as compared to the three and six months ended November 30, 2018, partially offset by a decrease in the number of active communities.

	As of November 30,	
	2019	2018
Backlog (units) at end of period:		
Entry-Level - Starlight Homes	330	150
Entry-Level - Ashton Woods	64	140
Move-up	182	301
Multi-Move-Up	137	178
Segment Total	713	769

Backlog consisted of 713 homes at November 30, 2019, which is a 7.3% decrease from 769 homes in backlog at November 30, 2018. Included in backlog at November 30, 2019 and November 30, 2018 were 262 and 9, respectively, wholesale home sales with real estate investors. The decrease in backlog is a result of selling 56 fewer homes than we closed during the twelve months ended November 30, 2019. The east segment sold 2,348 homes, while closing 2,404 homes during the twelve months ended November 30, 2019. Excluding the wholesale home sales with real estate investors, backlog decreased 41.4% (318 homes) as a result of a decrease in the number of active communities and the mix skewing towards entry-level Starlight Homes. The decrease in entry-level Starlight Homes backlog from 150 at November 30, 2018 to 68 at November 30, 2019 (excluding the wholesale sales) is primarily due to the accelerated close out of entry-level Starlight Homes communities due to these wholesale home sales and the timing of the opening of the replacement entry-level communities.

The sales value of backlog at November 30, 2019 was \$271.5 million, a 24.8% decrease compared to the sales value of backlog at November 30, 2018 of \$361.2 million, due primarily to a decrease in the average sales price of homes in backlog, as well as a decrease in the number of homes in backlog. The average sales price of homes in backlog at November 30, 2019 was \$381,000 compared to \$470,000 at November 30, 2018. The decrease in the average sales price of homes in backlog is a result of the mix of types of communities with homes in backlog. As discussed above, the shift in the mix of active communities has trended more towards those we consider to be entry-level, which typically have a lower average sales price. In addition, the wholesale home sales in backlog, which are generally sold at a discount to retail, typically have lower average sales prices than retail home sales. Of the 713 homes in backlog at November 30, 2019, 394 (55%) of the homes were considered entry-level (including 262 wholesale home sales), compared to 290 (38%) of the 769 homes in backlog at November 30, 2018, which included 9 wholesale home sales.

Net new home orders and backlog - Central segment

Net new home orders in the central segment increased 104.2% (370 homes) and 93.9% (694 homes) during the three and six months ended November 30, 2019, respectively, compared to the three and six months ended November 30, 2018. The increase in net new home orders was largely driven by an increase in the average sales pace per active community, as well as an increase in the number of active communities for the three and six months ended November 30, 2019, as compared to the three and six months ended November 30, 2018. As discussed above, our strategy has driven a shift in the mix of active communities at November 30, 2019, as compared to November 30, 2018 to a higher percentage of entry-level communities, which typically have a higher rate of sales.

	As of November 30,	
	2019	2018
Backlog (units) at end of period:		
Entry-Level - Starlight Homes	197	68
Entry-Level - Ashton Woods	295	112
Move-up	525	323
Multi-Move-Up	46	62
Segment Total	1,063	565

Backlog consisted of 1,063 homes at November 30, 2019, which is a 88.1% increase from 565 homes in backlog at November 30, 2018. The increase in backlog is the result of selling 498 more homes than were closed during the twelve months ended November 30, 2019. The central segment sold 2,785 homes, while closing 2,287 homes during the twelve months ended November 30, 2019.

The sales value of backlog at November 30, 2019 was \$383.4 million, a 58.5% increase over the sales value of backlog at November 30, 2018 of \$241.8 million due to the 88.1% increase in the number of homes in backlog as discussed above, offset in part by a decrease in the average sales price of homes in backlog. The average sales price of homes in backlog at November 30, 2019 was \$361,000 compared to \$428,000 at November 30, 2018. The decrease in the average sales price of homes in backlog is a result of the mix of types of communities with homes in backlog.

Home gross margins - Consolidated

The average gross margin from homes closed for the three months ended November 30, 2019 increased to 17.9% from 17.3% for the three months ended November 30, 2018. The increase in average gross margin for the three months ended November 30, 2019 was due primarily to the shift in community mix to entry-level communities, partially offset by elevated incentives on certain move-up and multi-move-up closings. We have generally seen higher gross margins in our entry-level communities, particularly in the Starlight Homes brand. During the three months ended November 30, 2019, 40.4% of closings were from entry-level communities in the Starlight Homes brand, compared to 28.2% of closings during the three months ended November 30, 2018. This was partially offset by continued elevated incentives in higher priced move-up and multi-move-up communities, particularly in the east segment. Beginning in the middle of last fiscal year, the softening demand for higher priced homes increased the incentives necessary to sell homes. While not at the same levels of incentives we saw during the middle of last fiscal year, incentives remain elevated in the higher priced communities.

The average gross margin from homes closed for the six months ended November 30, 2019 decreased to 17.0% from 17.6% for the six months ended November 30, 2018. The decrease in average gross margin for the six months ended November 30, 2019 was due primarily to elevated incentives on certain move-up and multi-move-up closings, offset in part by the shift in community mix to entry-level communities. Incentives were, and to a lesser extent remain, elevated due to the softening demand for higher priced homes. Many of the move-up and multi-move-up homes sold during the second half of last fiscal year, closed early in the current fiscal year. We have generally experienced higher gross margins on our entry-level communities, particularly in the Starlight Homes brand. During the six months ended November 30, 2019, 42.1% of closings were from entry-level communities in the Starlight Homes brand, as compared to 28.7% of closings for the six months ended November 30, 2018.

Adjusted gross margin from homes closed for the three months ended November 30, 2019 increased to 20.2% from 19.3% for the three months ended November 30, 2018. This increase in the adjusted gross margin was due to an increase in the interest amortized through cost of sales. Adjusted gross margin from homes closed for the six months ended November 30, 2019 decreased to 19.4% from 19.7% for the six months ended November 30, 2018. This decrease in the adjusted gross margin was due to the decrease in impairment charges, as discussed above, offset in part by an increase in the interest amortized through cost of sales.

Home gross margins - East segment

The average gross margin from homes closed in the east segment for the three and six months ended November 30, 2019 decreased to 15.9% and 14.9%, respectively, from 16.7% and 17.1% for the three and six months ended November 30, 2018, respectively. The decrease in average gross margin for the six months ended November 30, 2019 as compared to the six months ended November 30, 2018 was due primarily to elevated incentives on move-up and multi-move-up closings. Incentives were, and to a lesser extent remain, elevated due to the softening demand for higher priced homes. Many of the move-up and multi-move-up homes sold during the second half of last fiscal year closed early in the current fiscal year.

Home gross margins - Central segment

The average gross margin from homes closed in the central segment for the three and six months ended November 30, 2019 increased to 19.7% and 19.0%, respectively, from 18.1% and 18.8% for the three and six months ended November 30, 2018, respectively. The increase in average gross margin for the three and six months ended November 30, 2019 as compared to the three and six months ended November 30, 2018 was due primarily to the shift in community mix to more entry-level communities, which typically have a higher gross margin. During the three and six months ended November 30, 2019, 32.8% (196 homes) and 34.6% (388 homes) of closings were from entry-level communities in the Starlight Homes brand, respectively, compared to 15.6% (60 homes) and 15.2% (120 homes) of closings for the three and six months ended November 30, 2018.

Selling, general and administrative expenses

SG&A totaled \$53.4 million and \$107.2 million for the three and six months ended November 30, 2019, respectively, compared to \$47.6 million and \$95.7 million for the three and six months ended November 30, 2018, respectively. SG&A as a percentage of revenue increased to 14.2% and 14.5% for the three and six months ended November 30, 2019, respectively, from 14.1% and 13.8% for the three and six months ended November 30, 2018, respectively. The slight increase in SG&A as a percentage of revenue for the three months ended November 30, 2019 as compared to the three months ended November 30, 2018 was primarily related to an increase in legal settlements and fees, as a percentage of revenue, incurred in the ordinary course of business. The increase in SG&A as a percentage of revenue for the six months ended November 30, 2019 as compared to the six months ended November 30, 2018 was related to an increase in sales and marketing costs as a percentage of revenue due to a higher number of Starlight communities, which typically have higher marketing costs than Ashton Woods communities, and an increase in legal settlements and fees incurred in the normal course of business (including a \$1.4 million write-off related to the legal matter discussed in Note 12).

Land sales

We periodically elect to sell parcels of land or lots. We had \$6.0 million in sales of land and lots during both the three and six months ended November 30, 2019 and \$2.2 million and \$2.3 million in sales of land and lots during the three and six months ended November 30, 2018, respectively. As discussed in Note 1(d) to our unaudited condensed consolidated financial statements as of November 30, 2019, the Company recorded impairment charges on land that was held for sale of \$172.4 thousand during the six months ended November 30, 2019.

Net income

Net income increased \$4.3 million for the three months ended November 30, 2019 as compared to the three months ended November 30, 2018. Net income decreased \$4.4 million for the six months ended November 30, 2019 as compared to the six months ended November 30, 2018.

The increase in net income for the three months ended November 30, 2019 as compared to the three months ended November 30, 2018 is primarily attributable to an increase in revenues for the three months ended November 30, 2019 as compared to the three months ended November 30, 2018, and an increase in home gross margins for the three months ended November 30, 2019 as compared to the three months ended November 30, 2018, offset in part by a slight increase in SG&A expense as a percentage of revenue.

The decrease in net income for the six months ended November 30, 2019 as compared to the six months ended November 30, 2018 is primarily attributable to a decrease in home gross margins for the six months ended November 30, 2019 as compared to the six months ended November 30, 2018, and an increase in SG&A expense as a percentage of

revenue, offset in part by an increase in revenues for the six months ended November 30, 2019 as compared to the six months ended November 30, 2018.

Liquidity and capital resources

We currently fund our operations with proceeds from the sales of homes and land, borrowings under our Fifth Amended and Restated Credit Agreement, as amended and restated by the Second Amendment to Fifth Amended and Restated Credit Agreement dated as of August 28, 2019 (the “Restated Revolver”), and long-term financing. Our principal uses of cash are land and lot purchases, land development, home construction, repayments under our Restated Revolver, interest costs, overhead, and tax distributions. As we utilize our capital resources and liquidity to fund the growth of our business, we monitor our balance sheet leverage ratios to ensure that we maintain reasonable levels. We also monitor current and expected operational requirements, as well as financial market conditions, to evaluate accessing other available financing sources. Based on our existing financial condition and credit relationships, we believe that our operations and capital resources are sufficient to provide for our current and foreseeable capital needs. However, we continue to evaluate the impact of market conditions on our liquidity and will consider, as appropriate, additional funding opportunities.

Operating cash flows

Net cash used in operating activities for the six months ended November 30, 2019 was \$132.0 million compared to \$116.6 million of net cash used in operating activities for the six months ended November 30, 2018. The primary sources of funds from operations are from the closing of homes. The increase in net cash used in operations for the six months ended November 30, 2019 was primarily due to an increase in inventory of \$142.0 million as the result of land acquisition and development investments to support future operations, an increase in deposits on real estate under option or contract, and an increase in homes under construction.

Investing cash flows

Net cash used in investing activities was \$2.6 million for the six months ended November 30, 2019 and \$4.2 million for the six months ended November 30, 2018. Net cash used in investing activities for the six months ended November 30, 2019 included \$4.5 million to furnish and/or update furnishings in model homes and sales offices. The cash outflows were partially offset by a \$1.9 million return of investment in our unconsolidated entities.

Financing cash flows

Net cash provided by financing activities was \$134.5 million for the six months ended November 30, 2019, compared to \$93.1 million of cash provided by financing activities for the six months ended November 30, 2018. The funds provided by financing activities during the six months ended November 30, 2019 consisted of (i) \$144.9 million of net borrowings on the Restated Revolver, offset in part by (i) distributions of \$8.6 million to our Members, and (ii) \$1.9 million of debt issuance costs paid in connection with the amendment to the Restated Revolver. At November 30, 2019, we had outstanding borrowings of \$165.4 million under our Restated Revolver and available additional borrowing capacity of \$86.6 million based on outstanding letters of credit and the value of collateral pledged to secure the facility.

The total debt to total capitalization ratio consists of total debt divided by total capitalization (debt plus members’ equity). Our ratio of total debt to total capitalization decreased to 62.9% at November 30, 2019 from 63.7% at November 30, 2018. The net debt to net capitalization ratio consists of total debt, net of cash and restricted cash, divided by net capitalization (debt plus members’ equity), net of cash and restricted cash. Our ratio of net debt to net capitalization decreased to 62.9% at November 30, 2019 from 63.7% at November 30, 2018.

Inventory

As of November 30, 2019, we had the following owned homes in our reportable segments (in units):

	Homes Under Construction			Completed Homes			Total Homes
	Unsold	Models ⁽¹⁾	Sold	Unsold	Models ⁽²⁾	Sold	
East	670	13	343	267	52	166	1,511
Central	616	6	663	181	74	160	1,700
Company total	1,286	19	1,006	448	126	326	3,211

(1) Includes 15 models under the Ashton Woods brand name and 4 sales offices under the Starlight Homes brand name.

(2) Includes 96 models under the Ashton Woods brand name and 30 sales offices under the Starlight Homes brand name.

As of November 30, 2019, we controlled the following residential homes and lots (in units):

	Total Homes	Finished Lots	Land Under Development	Residential Land Held for Future Development	Total Owned	Total Under Option	Total Controlled
East	1,511	891	763	—	3,165	16,357	19,522
Central	1,700	1,086	1,979	1,073	5,838	13,654	19,492
Total Company	3,211	1,977	2,742	1,073	9,003	30,011	39,014
Percentage of total controlled	8.2%	5.1%	7.0%	2.8%	23.1%	76.9%	100.0%

As of November 30, 2019 and 2018, we had the following unsold homes in inventory (in units):

	As of November 30,	
	2019	2018
Entry-Level - Starlight Homes	697	498
Entry-Level - Ashton Woods	272	191
Move-up	537	565
Multi-Move-Up	227	239
Consolidated	1,733	1,493

The total number of unsold homes in inventory increased from 1,493 at November 30, 2018 to 1,733 at November 30, 2019. The increase is comprised of an increase of 196 unsold completed homes and an increase of 44 unsold homes under construction. The increase of 196 unsold completed homes is primarily driven by an increase in the entry-level communities in our Starlight Homes brand. These entry-level communities are focused on selling homes that are either already under construction or completed. The increase of 44 unsold homes under construction is primarily made up of an increase in our entry-level communities, as discussed above, including homes under construction in entry-level communities that have not yet opened for sales.

In addition to the 9,003 lots we owned, we controlled, through the use of purchase and option agreements, 30,011 lots at November 30, 2019. Purchase and option agreements that did not require consolidation under ASC 810, ASC 606, or ASC 470-40 at November 30, 2019 had an aggregate remaining purchase price of \$1.2 billion. In connection with these agreements, we had cash deposits of \$128.5 million at November 30, 2019. In addition, we had purchase and option agreements consolidated under ASC 606 or ASC 470-40 with an aggregate remaining purchase price of \$84.6 million and cash deposits of \$19.4 million (See Note 4 to our unaudited condensed consolidated financial statements as of November 30, 2019).

During the six months ended November 30, 2019, we acquired 3,343 lots for a total purchase price of \$195.9 million. We spent \$61.3 million on land development during the six months ended November 30, 2019. We spent \$4.5 million during the six months ended November 30, 2019 to furnish and/or update furnishings in model homes and sales offices.

Aggregate contractual commitments and off-balance sheet arrangements

Other than the amendment to the Company's Restated Revolver discussed in Note 6 to our unaudited condensed consolidated financial statements as of November 30, 2019, there have been no significant changes outside the ordinary course of business to our contractual obligations under our debt agreements and lease payments as of November 30, 2019, compared to those contained in our audited consolidated financial statements for the year ended May 31, 2019. Our debt obligations are fully discussed in Note 6 to our unaudited condensed consolidated financial statements as of November 30, 2019.

In the ordinary course of business, we provide letters of credit and surety bonds to third parties to secure performance and provide deposits under various contracts and commitments. At November 30, 2019, we had letters of credit and surety bonds outstanding of \$3.0 million and \$65.9 million, respectively. As of November 30, 2019, we had \$42.0 million of unused letter of credit capacity under the Restated Revolver.

At November 30, 2019, we controlled 39,014 lots and homes available to close. Of the 39,014 lots and homes controlled, we owned 23.1%, or 9,003 lots and homes, and 76.9%, or 30,011 lots, were under contract. In the ordinary course of business, we enter into purchase and option agreements in order to procure land for the construction of homes in the future. At November 30, 2019, these agreements had an aggregate remaining purchase price of \$1.2 billion, net of deposits of \$128.5 million. In addition, we had purchase and option agreements recorded under ASC 606 or ASC 470-40 with an aggregate remaining purchase price of \$84.6 million and cash deposits of \$19.4 million. Pursuant to these land purchase and land option agreements, we generally provide a deposit to the seller as consideration for the right, but not the obligation, to purchase land at different times in the future, usually at predetermined prices. In certain instances, we are required to record the land under option as if we own it.

As of November 30, 2019, real estate not owned totaled \$65.4 million related to seven lot purchase agreements with \$19.4 million of non-refundable deposits. Refer to our discussion in Note 4 to our unaudited condensed consolidated financial statements as of November 30, 2019.

As of November 30, 2019, we participated in one land development joint venture in which we have less than a controlling interest. We account for our interest in this joint venture under the equity method. Our share of profits from lots we purchase from the joint venture is deferred until we close on the home.

As of November 30, 2019, we participated in a mortgage joint venture in which the Company offers residential mortgage services to its homebuyers and the public at large in Austin, Dallas, Houston, San Antonio, Charleston, Raleigh, Orlando, Phoenix, and Southwest Florida. The Company does not have a controlling interest in the joint venture. We account for our interest in the mortgage joint venture under the equity method. Our share of profits is included within equity in earnings in unconsolidated entities in the unaudited condensed consolidated statements of income.

Seasonality and inflation

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

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

Critical accounting policies and estimates

There have been no significant changes to our critical accounting policies and estimates during the six months ended November 30, 2019, compared with those disclosed in our audited consolidated financial statements for the fiscal year ended May 31, 2019, except for the adoption of ASC 842, *Leases*, as discussed in Note 2 and Note 12 to our unaudited condensed consolidated financial statements as of November 30, 2019.

Transactions with related parties

See Note 9 to our unaudited condensed consolidated financial statements as of November 30, 2019 for transactions with related parties. The Company is a party to six lot purchase agreements with the Investors. A deposit ranging from 10% to 20% was required under each of the purchase agreements, and there are no specific performance requirements for the Company. The Company is a party to a lease as a lessee with the Investors to rent approximately 8,500 square feet of commercial space in Dallas, Texas. See the audited consolidated financial statements for the fiscal year ended May 31, 2019 for transactions existing at such date.

Pending accounting pronouncements

See Note 2 to our unaudited condensed consolidated financial statements as of November 30, 2019.

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

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

The borrowings under the Restated Revolver accrue interest at a variable rate. As of November 30, 2019, we had outstanding borrowings of \$165.4 million under the Restated Revolver.

Item 4. *Controls and Procedures*

Pursuant to section 4.03 of each of the indentures governing the 9.875% Notes and 6.750% Notes, the Company is not required to comply with Section 302 or Section 404 of the Sarbanes-Oxley Act of 2002, or related Items 307 and 308 of Regulation S-K promulgated by the Securities and Exchange Commission.

PART II. OTHER INFORMATION

Item 1. *Legal Proceedings*

We are involved in lawsuits and other contingencies in the ordinary course of business. The amounts demanded by the claimants in these lawsuits and claims may vary widely, with large demands made in certain cases, which are disputed and aggressively defended by the Company. Management believes that, while the ultimate outcome of these ordinary course contingencies cannot be predicted with certainty, the ultimate liability, if any, net of anticipated recoveries including from any insurance, will not have a material adverse effect on our financial condition, results of operations or cash flows.

In addition, on June 27, 2016, FCC Marsh, LLC (the “Seller”) filed a complaint against Ashton Tampa Residential, LLC, a wholly owned subsidiary of Ashton Woods USA L.L.C. (“Ashton Woods USA”), in the Circuit Court for Collier County, Florida, alleging that the Company breached a lot purchase agreement that provided the Seller with a specific performance right against the Company, subject to certain conditions, by allegedly failing to close on certain lot purchases. The Seller dismissed its claim for specific performance, and seeks declaratory relief and damages. The Company filed a counterclaim seeking declaratory relief, return of the earnest money deposit, foreclosure of the mortgage that secures that deposit, and damages for the Seller's breach of a lease agreement between the parties. On April 5, 2019, the Seller filed a motion to amend its complaint to add Ashton Woods USA as a defendant, and to assert a tortious interference claim against Ashton Woods USA, which motion was granted by the court. Subsequently, on April 30, 2019, the Seller filed a separate complaint against Ashton Woods USA in the Circuit Court for Collier County, Florida asserting the identical tortious interference claim. Ashton Woods USA filed a motion to dismiss the complaint, which was then voluntarily dismissed by the Seller. At a hearing on September 16, 2019, the court granted the Seller's motion for summary judgment on the Company's claim for declaratory relief with respect to the \$1.4 million earnest money deposit and ordered that those funds be released to the Seller. In July 2019, FCC Marsh submitted an expert report in which they claim \$20.3 million in damages. The Company vigorously denies that it caused FCC Marsh any damages. In addition, in October 2019, the court entered an order requiring the parties to mediate the lawsuit, which is currently scheduled to occur in January 2020. The parties have filed cross motions for partial summary judgment, and the court has entered an order that currently sets the lawsuit on the March 30, 2020 trial docket. While it is premature to predict the ultimate outcome of these proceedings, the Company intends to vigorously defend the lawsuit and pursue its claim against the Seller.