NOT FILED WITH THE SEC

THIS QUARTERLY REPORT IS BEING PREPARED PURSUANT TO REQUIREMENTS CONTAINED 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, 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 JANUARY 23, 2020 GOVERNING THE 6.625% SENIOR NOTES DUE 2028 ISSUED BY ASHTON WOODS USA L.L.C..

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

For the quarterly period ended August 31, 2020

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	**37-1590746**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
3820 Mansell Road, Suite 400 **Alpharetta, GA**	**30022**
(Address of Principal Executive Offices)	(Zip Code)

(770) 998-9663

Registrant's telephone number, including area code

Securities registered pursuant to Section 12(b) of the Act:	Securities registered pursuant to Section 12(g) of the Act:
Title of Each Class	Title of Each Class
NONE	**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 [X]

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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
[ ]	[ ]	[X]	[ ]	[ ]

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 [X]

ASHTON WOODS USA L.L.C.
INDEX TO FORM 10-Q

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Review Report of Independent Auditors

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

We have reviewed the condensed consolidated financial information of Ashton Woods USA L.L.C., which comprise the condensed consolidated balance sheet as of August 31, 2020, and the related condensed consolidated statements of income and cash flows for the three-month periods ended August 31, 2020 and 2019, and the condensed consolidated statements of changes in members' equity for each of the three-month periods in the period from May 31, 2019 to August 31, 2020.

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, 2020

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, 2020, 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 15, 2020. In our opinion, the accompanying condensed consolidated balance sheet of Ashton Woods USA L.L.C. as of May 31, 2020, is consistent, in all material respects, with the consolidated balance sheet from which it has been derived.

Ernst & Young LLP

October 13, 2020

PART I. FINANCIAL INFORMATION

Item 1. *Financial Statements*

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

	August 31, 2020	May 31, 2020
Assets:		
Cash and cash equivalents	$ 246,674	$ 255,314
Restricted cash	1,102	3,059
Receivables	34,843	33,683
Inventory	905,168	882,002
Property and equipment, net	10,667	11,217
Investments in unconsolidated entities	3,486	4,608
Deposits on real estate under option or contract	151,985	143,989
Other assets	120,483	118,373
Total assets	$ 1,474,408	$ 1,452,245
Liabilities and members' equity:		
Liabilities:		
Accounts payable	$ 93,096	$ 70,447
Other liabilities	147,109	167,375
Customer deposits	23,654	17,580
Debt	746,301	746,395
Total liabilities	1,010,160	1,001,797
Commitments and contingencies (Note 12)		
Members' equity:	464,248	450,448
Total liabilities and members' equity	$ 1,474,408	$ 1,452,245

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 August 31, 2020	Three months ended August 31, 2019
	(Unaudited)	
Revenues:		
Home sales	$ 413,826	$ 363,434
Land sales	65	—
Financial services and other revenues	9,591	6,735
	423,482	370,169
Cost of sales:		
Cost of sales homes	335,286	305,176
Cost of sales land	74	28
Cost of sales financial services and other revenues	7,203	4,407
	342,563	309,611
Gross profit	80,919	60,558
Other expense (income):		
Selling, general and administrative	55,287	53,797
Interest expense	7,429	2,776
Depreciation and amortization	2,182	2,352
Other income	(230)	(562)
	64,668	58,363
Equity in earnings of unconsolidated entities	1,499	968
Net income	$ 17,750	$ 3,163

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, 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
Net income	5,710	1,403	7,561	14,674
Distributions	(1,518)	(373)	(2,009)	(3,900)
Members' equity at February 28, 2020 (Unaudited)	$ 151,581	$ 33,530	$ 220,297	$ 405,408
Net income	17,525	4,310	23,205	45,040
Members' equity at May 31, 2020 (Audited)	$ 169,106	$ 37,840	$ 243,502	$ 450,448
Net income	6,907	1,698	9,145	17,750
Distributions	(1,537)	(378)	(2,035)	(3,950)
Members' equity at August 31, 2020 (Unaudited)	$ 174,476	$ 39,160	$ 250,612	$ 464,248

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Three months ended August 31,	
	2020	**2019**
	(Unaudited)	
Cash flows from operating activities:		
Net income	$ 17,750	$ 3,163
Adjustments to reconcile net income to net cash used in operating activities:		
Equity in earnings of unconsolidated entities	(1,499)	(968)
Returns on investments in unconsolidated entities	2,448	1,759
Long-term compensation expense	1,820	998
Inventory impairments	25	407
Depreciation and amortization	2,182	2,352
Changes in operating assets and liabilities:		
Inventory	(23,068)	(53,915)
Receivables	(1,160)	(7,620)
Deposits on real estate under option or contract	(7,996)	(2,385)
Other assets	(3,167)	6,759
Accounts payable	22,649	(6,359)
Other liabilities	(20,917)	(22,514)
Customer deposits	6,074	3,030
Net cash used in operating activities	(4,859)	(75,293)
Cash flows from investing activities:		
Returns of investments in unconsolidated entities	—	1,372
Additions to property and equipment	(1,732)	(2,280)
Net cash used in investing activities	(1,732)	(908)
Cash flows from financing activities:		
Borrowings from revolving credit facility	—	299,700
Repayments of revolving credit facility	—	(214,999)
Payment of debt issuance costs	(56)	(1,700)
Members' distributions	(3,950)	(6,950)
Net cash (used in) provided by financing activities	(4,006)	76,051
Change in cash, cash equivalents, and restricted cash	(10,597)	(150)
Cash, cash equivalents, and restricted cash, beginning of period	258,373	189
Cash, cash equivalents, and restricted cash, end of period	$ 247,776	$ 39
Supplemental cash flow information:		
Cash paid for interest, net of amounts capitalized	$ 6,835	$ 1,862

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 August 31,	
	2020	2019
Cash and cash equivalents	$ 246,674	$ —
Restricted cash	1,102	39
Total cash, cash equivalents, and restricted cash	$ 247,776	$ 39

Supplemental disclosures of cash flows information:

	Three months ended August 31,	
	2020	2019
Right-of-use assets obtained in exchange for new operating lease liabilities	$ 52	$ —

See accompanying notes to unaudited condensed consolidated financial statements.

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. As of August 31, 2020, 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 also offers title services to its homebuyers in its Austin, Dallas, Houston, San Antonio, Charleston, 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. Restricted cash consists of amounts held in restricted accounts as collateral for letters of credit issued and outstanding, as permitted by the Company's senior secured revolving credit facility, and other investments.

(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 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 three months ended August 31, 2020, inventory impairment charges totaling $24.6 thousand were recognized. The inventory impairment charges consisted 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. The Company recorded inventory impairment charges of $0.4 million during the three months ended August 31, 2019, which consisted of $384.3 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 $23.8 thousand 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 and the current impacts and uncertainties of COVID-19, 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 August 31, 2020 and May 31, 2020 consisted of the following (in thousands):

	August 31, 2020	May 31, 2020
Closing funds due	$ 4,762	$ 6,373
Land development receivables	16,036	13,957
MUD receivables (1)	9,759	10,280
Other receivables (2)	4,286	3,073
	$ 34,843	$ 33,683

(1) Includes certain land development costs to be reimbursed by four 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 impairments during the three months ended August 31, 2020 and 2019 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 $0.5 million and $0.6 million for the three months ended August 31, 2020 and 2019, 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 August 31, 2020 and May 31, 2020 consisted of the following (in thousands):

	August 31, 2020	May 31, 2020
Office furniture and equipment	$ 3,844	$ 3,852
Sales offices, design studios, and model furnishings	33,487	32,863
Leasehold improvements	2,438	2,414
	39,769	39,129
Accumulated depreciation and amortization(1)	(29,102)	(27,912)
	$ 10,667	$ 11,217

(1) Net of retirements and disposals.

Depreciation and amortization expense approximated $2.2 million and $2.4 million for the three months ended August 31, 2020 and 2019, respectively.

(j) Revenue recognition

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 $4.8 million and $6.4 million at August 31, 2020 and May 31, 2020, 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 $23.7 million and $17.6 million at August 31, 2020 and May 31, 2020, respectively. Of the customer deposit liabilities at May 31, 2020, $8.6 million was recognized in revenues in the three months ended August 31, 2020 upon the closing of the related homes. Also included in home sale revenues are our wholesale home sales within our Starlight Homes brand. Wholesale home sales primarily consist of completed homes sold under bulk sales agreements to real estate investors who intend to use the homes as rental properties. See Note 1(l) 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. There were no land sale contract assets or liabilities at August 31, 2020 and May 31, 2020.

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 revenues also include 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.

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.

(k) Prepaid expenses

Included in other assets are prepaid expenses of approximately $8.8 million and $8.9 million as of August 31, 2020 and May 31, 2020, 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 months ended August 31, 2020 and 2019 (in thousands):

	Three months ended August 31, 2020	Three months ended August 31, 2019
Warranty liability, beginning of period	$ 10,122	$ 11,933
Costs accrued during period	2,989	2,548
Costs incurred during period	(2,943)	(3,788)
Warranty liability, end of period	$ 10,168	$ 10,693

(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 $1.6 million and $3.6 million for the three months ended August 31, 2020 and 2019, 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 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 6.750% Senior Notes due 2025 (the "6.750% Notes"), its 9.875% Senior Notes due 2027 (the "9.875% Notes"), and its 6.625% Senior Notes due 2028 (the "6.625% Notes"). Any tax distributions made to the Members are treated as a reduction of equity. The Company made tax distributions to its Members of $4.0 million and $7.0 million during the three months ended August 31, 2020 and 2019, 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) Risks and uncertainties

The worldwide spread of COVID-19 virus has caused broad business and social disruption across many industries and locations, both domestically and abroad. Further, the spread of COVID-19 has also caused significant volatility in U.S. and international debt and equity markets. To date, COVID-19 has caused significant negative impacts across our industry, from trade availability, increases in the cost of certain building materials, suspension of services in local municipalities, delays in homes closings, increased cancellations, various and differing shelter in place orders by state, county, and other local municipalities, and disruptions to normal operating procedures, to volatile economic conditions and a decline in consumer confidence. There is significant uncertainty around the breadth, severity, and duration of COVID-19 and the business disruptions related to COVID-19, as well as its impact on the U.S. and international economies, consumer confidence and, in turn, the impact it will have on our results.

(s) Subsequent events

The Company has evaluated subsequent events through October 13, 2020. This date represents the date on which the consolidated financial statements were available to be issued.

On October 13, 2020, the Board of Directors of the Company approved tax distributions of $9.6 million to its Members based on estimates of its Members' tax liability related to their share of the Company's taxable income.

Note 2 — Pending and Recently Adopted Accounting Pronouncements

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 effects 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 condensed consolidated financial statements and related disclosures.

In March 2020, the FASB issued ASU No. 2020-04, *Reference Rate Reform* ("ASU 2020-04"), which provides optional expedients and exceptions for applying U.S. GAAP to contracts, hedging relationships, and other transactions affected by the discontinuation of the London Interbank Offered Rate (LIBOR) or by another reference rate expected to be discontinued. ASU 2020-04 is effective beginning March 12, 2020 and can be applied prospectively through December 31, 2022. The Company has not elected to apply any of the expedients or exceptions of ASU 2020-04 to date and is currently evaluating the impact the guidance under ASU 2020-04 may have on its condensed consolidated financial statements and related disclosures in future periods.

Note 3 — Inventory

Inventory consisted of the following at August 31, 2020 and May 31, 2020 (in thousands):

	August 31, 2020	May 31, 2020
Homes under construction and finished homes	$ 547,517	$ 545,079
Finished lots	239,991	215,419
Land under development	90,828	86,964
Land held for future development	20,814	28,231
Land held for sale	6,018	6,309
	$ 905,168	$ 882,002

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 $7.4 million and $2.8 million for the three months ended August 31, 2020 and 2019, 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 months ended August 31, 2020 and 2019 (in thousands):

	Three months ended August 31,	
	2020	2019
Capitalized interest, beginning of period	$ 21,646	$ 19,040
Interest incurred	15,974	12,963
Interest amortized to cost of sales	(9,003)	(8,743)
Interest expensed	(7,429)	(2,776)
Capitalized interest, end of period	$ 21,188	$ 20,484

Note 4 — Other Assets

Other assets at August 31, 2020 and May 31, 2020 consisted of the following (in thousands):

	August 31, 2020	May 31, 2020
Real estate not owned	$ 83,971	$ 79,738
Right-of-use assets(1)	12,125	13,121
Prepaid expenses	8,815	8,885
Architecture plans	4,483	4,626
Deferred financing fees	2,550	2,725
Pre-acquisition costs	6,531	7,161
Other deposits	2,008	2,117
	$ 120,483	$ 118,373

(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 August 31, 2020 and May 31, 2020, 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 one lot purchase agreement with an unaffiliated investor group that is accounted for pursuant to ASC 470-40. At August 31, 2020 and May 31, 2020, the Company recorded real estate not owned of $23.9 million and $24.9 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 August 31, 2020 and May 31, 2020, the Company recorded real estate not owned of $60.1 million and $54.9 million, respectively, for the sale of lots because its repurchase agreements related to this real estate were considered to be financing arrangements. While these option agreements contain no specific performance obligations, should the Company choose not to purchase the land, it will forfeit the deposited amount.

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. The Company incurred deferred financing fees of $51.0

thousand and $1.7 million during the three months ended August 31, 2020 and 2019, respectively, as a result of the amendment to the Company's senior secured revolving credit facility as discussed below in Note 6.

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 August 31, 2020, 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 Company has entered into a lot purchase agreement with the joint venture that permits but does not require 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 August 31, 2020, the Company had recorded $1.1 million for its investment in this unconsolidated entity in the unaudited condensed consolidated balance sheets. 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 $6.0 thousand 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 August 31, 2020, the total purchase price of lots remaining to be purchased under this agreement was approximately $14.5 million. As of August 31, 2020, the joint venture had $4.8 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 August 31, 2020 and May 31, 2020 and for the three months ended August 31, 2020 and 2019 was as follows (in thousands):

	August 31, 2020	May 31, 2020
Assets:		
Cash	$ 4,473	$ 5,650
Mortgage notes receivable	31,096	54,472
Real estate	9,728	9,384
Other	910	713
Total assets	$ 46,207	$ 70,219
Liabilities and equity:		
Liabilities:		
Accounts payable and other accruals	$ 4,277	$ 5,274
Notes payable [1]	34,917	55,643
Total liabilities	39,194	60,917
Equity	7,013	9,302
Total liabilities and equity	$ 46,207	$ 70,219

(1) The notes payable balance at August 31, 2020 is comprised of $30.1 million outstanding on two warehouse lines and $4.8 million of secured debt, all of which is non-recourse to the Company. The notes payable balance at May 31, 2020 is comprised of $52.0 million outstanding on two warehouse lines and $3.7 million of secured debt, all of which is non-recourse to the Company.

	Three months ended August 31,	
	2020	2019
Revenues:		
Lot sales	$ —	$ 2,977
Financial services	5,599	3,641
Total revenues	5,599	6,618
Gross profit	3,491	2,887
General and administrative expenses:		
Financial services	785	675
Total general and administrative expenses	785	675
Net earnings	$ 2,707	$ 2,212

Note 6 — Debt

Debt at August 31, 2020 and May 31, 2020 consisted of the following (in thousands):

	August 31, 2020	May 31, 2020
6.750% Notes (1)	$ 247,054	$ 246,878
9.875% Notes (2)	249,434	249,182
6.625% Notes (3)	245,788	245,610
Note payable	4,025	4,725
	$ 746,301	$ 746,395

(1) Net of $2.9 million and $3.1 million of unamortized deferred financing costs as of August 31, 2020 and May 31, 2020, respectively.
(2) Net of $4.0 million and $4.2 million of unamortized deferred financing costs and $1.6 million of unamortized discount as of both August 31, 2020 and May 31, 2020.
(3) Net of $4.2 million and $4.4 million of unamortized deferred financing costs as of August 31, 2020 and May 31, 2020, respectively.

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. 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) from August 1, 2020 until August 1, 2023, 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 (b) 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 August 31, 2020, the Company was in compliance with the covenants in the indenture governing the 6.750% Notes.

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, 2022, 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 9.875% Notes, (b) on or after April 1, 2022 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 (c) 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 August 31, 2020, the Company was in compliance with the covenants in the indenture governing the 9.875% Notes.

The 6.625% Notes

On January 23, 2020, the Company issued $250.0 million principal amount of 6.625% Senior Notes due 2028 (the "6.625% Notes") in a private offering pursuant to Rule 144A and Regulation S under the Securities Act of 1933, as amended. The 6.625% Notes were issued at a price of 100.00% of the principal amount to yield 6.625%.

The 6.625% Notes mature on January 15, 2028. Interest is payable on the 6.625% Notes on January 15 and July 15 of each year. The 6.625% Notes are senior, unsecured obligations of the Company and rank equally in right of payment to all of the Company's existing and future senior debt and senior in right of payment to the Company's existing and future subordinated debt. The 6.625% Notes are effectively subordinated to any of the Company's existing and future secured debt, including the Company's senior secured revolving credit facility, to the extent of the value of the assets securing such debt. The obligations under the 6.625% 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 6.625% Notes, with the exception of AW Mortgage Holdings L.L.C., which has been designated an Unrestricted Subsidiary pursuant to the indenture governing the 6.625% Notes.

The indenture governing the 6.625% Notes gives the Company the option to redeem the 6.625% Notes at any time or from time to time, in whole or in part, (a) until January 15, 2023, 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 6.625% Notes, (b) on or after January 15, 2023 until January 15, 2026, at certain redemption prices set forth in the indenture governing the 6.625% Notes together with accrued and unpaid interest thereon, if any, to and excluding the redemption date, and (c) on or after January 15, 2026, 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 6.625% 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 August 31, 2020, the Company was in compliance with the covenants in the indenture governing the 6.625% 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, 9.875% Notes, and 6.625% 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, permits certain tax distributions to Members and permits certain other distributions to Members if certain Leverage Ratio and other conditions are met. As of August 31, 2020, the Company was in compliance with the covenants in the Restated Revolver.

At August 31, 2020, there were no borrowings outstanding under the Restated Revolver and $0.8 million of letters of credit outstanding. As of August 31, 2020, the Company had available additional borrowing capacity of $247.2 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 Payable

On December 13, 2019, the Company issued a $4.7 million note payable to an unaffiliated third party, related to a purchase of land, which matures on July 13, 2022. The note payable has an interest rate of 10.00%. The note is collateralized by the land to which it relates and has no recourse to any other assets or to the Company. As of August 31, 2020, the outstanding note payable balance, including accrued interest, totaled $4.0 million.

Note 7 — Other Liabilities

Other liabilities at August 31, 2020 and May 31, 2020 consisted of the following (in thousands):

	August 31, 2020	May 31, 2020
Liabilities related to real estate not owned (1)	$ 54,312	$ 55,210
Salaries, bonuses, and benefits	15,761	35,080
Lease liabilities(2)	13,656	14,410
Accrued interest	14,037	15,718
Warranty accruals	10,168	10,122
Accrued long-term compensation	10,867	12,674
Accrued real estate taxes	6,453	4,027
Other	21,855	20,134
	$ 147,109	$ 167,375

(1) Net of deposits of $29.7 million and $23.3 million in August 31, 2020 and May 31, 2020, 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.

At August 31, 2020, 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 %
	20,628,729	100.00 %	

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 $1.0 million and $0.2 million during the three months ended August 31, 2020 and 2019, respectively, under the services agreement. As of August 31, 2020 and May 31, 2020, the balance due to the Investors under the terms of the service agreement was $1.0 million and $1.4 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 28 months remaining on the lease as of August 31, 2020. Total minimum lease payments due under the lease were $0.3 million as of both August 31, 2020 and May 31, 2020.

Lot purchase agreements

The Company is a party to nine 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 required to record one of these lot purchase agreements as real estate not owned in the unaudited condensed consolidated balance sheets. As of August 31, 2020, the total purchase price of lots remaining to be purchased under such agreements was approximately $50.3 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 August 31, 2020, the total purchase price of lots remaining to be purchased was $14.5 million. As of August 31, 2020, the joint venture had $4.8 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 2020, 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 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 three months ended August 31, 2020:

	Full-value shares	Appreciation-only shares	Total shares
Outstanding performance shares as of May 31, 2020	239,633	703,922	943,555
Performance shares awarded during the period	119,274	238,548	357,822
Shares forfeited during the period	—	—	—
Fully vested performance shares paid	(74,388)	(82,559)	(156,947)
Total outstanding performance shares as of August 31, 2020	284,519	859,911	1,144,430
Total vested performance shares as of August 31, 2020	106,113	503,103	609,216

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 August 31, 2020 and May 31, 2020 was 609,216 and 695,110, respectively. The Company recorded \$1.8 million and \$1.0 million for the three months ended August 31, 2020 and 2019, respectively, in compensation expense associated with the full-value and appreciation-only performance shares. For the three months ended August 31, 2020 and 2019, \$3.6 million (156,947 units) and \$2.9 million (142,240 units), respectively, of vested performance shares were paid out to employees. As of August 31, 2020 and May 31, 2020, the Company's liability for the performance shares was \$10.9 million and \$12.7 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:	**Three months ended August 31, 2020**
Average selling price	\$300,000 - \$847,000
Annual discount rate	12%

The following table presents the carrying amounts and estimated fair values of the Company's 6.750% Notes, 9.875% Notes, and 6.625% Notes at August 31, 2020 and May 31, 2020:

		August 31, 2020		**May 31, 2020**	
	Fair Value Hierarchy	**Carrying Amount**	**Fair Value**	**Carrying Amount**	**Fair Value**
Liabilities:		(in thousands)			
6.750% Notes	Level 2	\$ 247,054	\$ 252,500	\$ 246,878	\$ 237,500
9.875% Notes	Level 2	249,434	280,500	249,182	263,288
6.625% Notes	Level 2	245,788	251,250	245,610	226,875
		\$ 742,276	\$ 784,250	\$ 741,670	\$ 727,663

The Company's 6.750% Notes, 9.875% Notes, and 6.625% 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 6.750% Notes, 9.875% Notes, and 6.625% Notes reflect their face amount, adjusted for any unamortized debt issuance costs and discount. The fair values of the 6.750% Notes, 9.875% Notes, and 6.625% 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. The Company establishes liabilities for legal claims and related matters when such matters are both probable of occurring and any potential loss is reasonably estimable. The Company accrues for such matters based on the facts and circumstances specific to each matter and revise these estimates as the matters evolve. In such cases, there may exist an exposure to loss in excess of any amounts currently accrued. In view of the inherent difficulty of predicting the outcome of these legal and related matters, we generally cannot predict the ultimate resolution of the pending matters, the related timing, or the eventual loss. While the outcome of such contingencies cannot be predicted with certainty, we do not believe that the resolution of such matters will have a material adverse effect on the Company's results of operations, financial condition, or cash flows. However, to the extent the liability arising from the ultimate resolution of any matter exceeds the estimates reflected in the recorded reserves relating to such matter, we could incur additional charges that could be significant.

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 August 31, 2020 and May 31, 2020, the Company had letters of credit outstanding of $0.8 million and $2.7 million, respectively, and surety bonds outstanding of $81.3 million and $73.6 million, respectively. As of August 31, 2020, the Company had $49.2 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 August 31, 2020, the Company has made nonrefundable deposits of $180.5 million, which includes $29.7 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 $1.3 billion as of August 31, 2020.

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 sheets 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 $12.1 million and $13.7 million at August 31, 2020, respectively, and $13.1 million and $14.4 million at May 31, 2020, respectively. During the three months ended August 31, 2020, there was $0.1 million of additions to the right-of-use assets under operating leases. There were no additions to the right-of-use assets under operating leases during the three months ended August 31, 2019. Payments on Lease liabilities during both the three months ended August 31, 2020 and 2019 totaled $0.9 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 three months ended August 31, 2020 and 2019 our total lease expense approximated $1.3 million and $1.5 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 August 31, 2020 are as follows (in thousands):

Year ending May 31, 2021	$	2,374
Year ending May 31, 2022		3,496
Year ending May 31, 2023		3,140
Year ending May 31, 2024		2,261
Year ending May 31, 2025		2,106
Thereafter		4,677
Total future minimum lease payments[(a)]		18,054
Less: Interest [(b)(c)]		4,398
Total future minimum lease payments less interest[(c)]	$	13,656

(a) Lease payments include options to extend lease terms that are reasonably certain of being exercised.
(b) 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.
(c) The weighted average lease term and weighted average discount rate used in calculating our Lease liabilities were 4.6 years and 7.8%, respectively, at August 31, 2020.

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 August 31,	
Revenues:	**2020**	**2019**
Homebuilding:		
East	$ 203,141	$ 186,626
Central	210,685	176,808
Total homebuilding revenues	413,826	363,434
Land sales	65	—
Financial services and other revenue	9,591	6,735
Total revenues	$ 423,482	$ 370,169
Gross profit [(1)]:		
Homebuilding:		
East	$ 32,419	$ 26,021
Central	46,121	32,237
Total homebuilding gross profit	78,540	58,258
Land sales gross profit	(9)	(28)
Financial services and other revenue gross profit	2,388	2,328
Total gross profit	$ 80,919	$ 60,558

Depreciation and amortization:		
East	$ 871	$ 1,075
Central	1,283	1,260
Total depreciation and amortization	$ 2,154	$ 2,335
Equity in earnings of unconsolidated entities:		
East	$ 316	$ 94
Central	1,183	874
Total equity in earnings of unconsolidated entities	$ 1,499	$ 968
Net income (loss):		
East	$ 3,672	$ (741)
Central	18,732	6,528
	22,404	5,787
Other (2)	(4,654)	(2,624)
Total net income	$ 17,750	$ 3,163

(1) Includes inventory impairments on homes totaling $0.3 million for the east segment during the three months ended August 31, 2019, and $24.6 thousand and $41.0 thousand for the central segment during the three months ended August 31, 2020 and 2019, respectively. There were no inventory impairments on homes for the east segment during the three months ended August 31, 2020.

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

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

	August 31, 2020	May 31, 2020
Assets:		
Homebuilding:		
East	$ 616,369	$ 644,009
Central	599,265	537,735
	1,215,634	1,181,744
Other (1)	258,774	270,501
Total assets	$ 1,474,408	$ 1,452,245

(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 August 31,	
	2020	2019
Additions to property and equipment:		
Homebuilding:		
East	$ 447	$ 791
Central	1,273	1,489
	1,720	2,280
Other (1)	12	—
Total additions to property and equipment	$ 1,732	$ 2,280

(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 included elsewhere in this quarterly report and with our annual report on Form 10-K for the fiscal year ended May 31, 2020. 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:

- The potential negative impact of the COVID-19 pandemic, which, in addition to exacerbating each of the risks listed below, may include a significant decrease in demand for our homes or consumer confidence generally with respect to purchasing a home, an inability to sell, build, and close homes in a typical manner or at all, increased costs or decreased supply of building materials or disruptions in the availability of subcontractors, housing inspectors, and other third-parties we rely on to support our operations, the availability of residential mortgage financing, and the recognition of charges in future periods, which may be material, for inventory impairments and/or land option contract abandonments;
- Reversal of the previous homebuilding recovery or continued or further 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, epidemics or pandemics, social or political unrest or uncertainty, 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, 2020, over which the Company has little or no control.

Overview and Outlook

COVID-19

COVID-19 has had a material impact on the global and United States economies, and has impacted our business operations. There has been continuing business uncertainty surrounding COVID-19, due to rapidly changing governmental orders, public health concerns, the resulting market reactions, a significant increase in the unemployment rate, and the behavior of potential homebuyers. Responses to COVID-19 have included, among other things, varying degrees of quarantines, "stay-at-home" or "shelter-in-place" orders, and similar mandates for many individuals, which in some instances have substantially restricted daily activities and have required many businesses to curtail or cease normal operations.

The current environment makes it challenging to predict the impact that the pandemic may have on the future performance of our business. Our primary concern is the health and well-being of our employees, customers, business partners, and the communities we serve. In particular, between March and April, we closed our sales centers, model homes, and Design Studios to the general public, and our sales teams shifted to a virtual or appointment-only home sales process and leveraged digital sales tools to connect with our customers online. While we have since re-opened our sales centers, model homes, and Design Studios to the general public, we are currently limiting the number of individuals in these venues and are following other public health recommendations in an effort to protect our employees and customers. The state and local governments in all of the markets in which we operate have designated residential construction as an essential business as part of critical infrastructure and are currently allowing the construction and sales of homes. We are following recommended social distancing and other health and safety protocols when meeting in person with customers and continue to operate our corporate and division office functions remotely. In the field, we have implemented construction site health and safety guidelines in an effort to adhere to social distancing and other public health-related recommendations and requirements.

As restrictions on our business and normal daily activities began to be put in place in March 2020, we made a number of strategic decisions that focused on cash generation and preservation, including drawing down funds under our revolving credit facility, slowing and delaying the construction of homes, delaying openings of new communities, and restructuring and delaying land investments. As we started seeing a strong demand for new homes beginning in late April 2020, and continuing through August 2020, we have been strategically starting construction on additional homes, making new land investments, and developing land we own, while continuing to focus on maintaining adequate liquidity through the uncertain times ahead. While we saw a slowdown in sales through late April with the emergence of COVID-19 in March, sales began to increase in late April and May, and our cancellation rates returned to normal levels. Sales have remained strong through August 2020. For the first quarter of fiscal year 2021, our new home sales orders increase by 40% compared to the prior year quarter.

The demand in the new home market has likely been affected by increased buyer urgency due to low interest rates on mortgage loans, the limited supply of homes at affordable price points across our markets and, to some extent the lower levels of homes sales from mid-March through late April, which caused some pent-up demand. In addition, resale home inventory levels remain low in our markets, adding to the demand for finished new homes.

Even with the resurgence of demand, we remain cautious as to the impact that COVID-19 may have on our operations and on the overall economy in the future. There is significant uncertainty regarding the extent to which and how long COVID-19 and its related effects will impact the U.S. and global economy, and the level of unemployment, availability of debt, capital, the health of the mortgage markets, consumer confidence, and demand for our homes. In addition, our operations could be impacted by elongated cycle times due to lack of availability of trade labor and building materials, as well as the responsiveness of government services such as zoning, permitting and related government approvals. We may also be impacted by lack of availability and rising costs of trade labor. The extent to which these impact our operational and financial performance will depend upon future developments, including the duration and spread of COVID-19 and the impact on our customers, trade partners and employees. In addition, as the resurgence of demand has caused an increase in the construction of new homes, the pricing of building materials, most notably lumber, has increased significantly. While a lot of these increases are impacting homes that have not yet closed, we anticipate future closings to be impacted by the rising costs.

Business

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, homes that include attractive features, without offering customers the opportunity to personalize their homes.

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

	Three months ended August 31,	
	2020	**2019**
Net new home orders (units):		
Entry-Level - Starlight Homes	759	584
Entry-Level - Ashton Woods	364	179
Move-up - Ashton Woods	602	499
Multi-Move-Up - Ashton Woods	178	97
Company Total	1,903	1,359
Homes closed (units):		
Entry-Level - Starlight Homes	576	458
Entry-Level - Ashton Woods	195	113
Move-up - Ashton Woods	381	365
Multi-Move-Up - Ashton Woods	90	106
Company Total	1,242	1,042

	As of August 31,	
	2020	**2019**
Backlog (units) at end of period:		
Entry-Level - Starlight Homes	666	448
Entry-Level - Ashton Woods	443	255
Move-up - Ashton Woods	817	739
Multi-Move-Up - Ashton Woods	243	183
Company Total	2,169	1,625

	As of August 31,	
	2020	**2019**
Active communities:		
Entry-Level - Starlight Homes	31	24
Entry-Level - Ashton Woods	27	19
Move-up - Ashton Woods	51	65
Multi-Move-Up - Ashton Woods	24	20
Company Total	133	128

	Three months ended August 31,	
	2020	2019
Average monthly sales per average active community: (1)		
Entry-Level - Starlight Homes	8.3	7.8
Entry-Level - Ashton Woods	4.5	3.6
Move-up - Ashton Woods	3.6	2.5
Multi-Move-Up - Ashton Woods	2.6	1.5
Company Average	4.7	3.5

(1) Average active community for the three months ended August 31, 2020 is calculated by averaging the active community counts at August 31, 2020 and May 31, 2020 and for the three months ended August 31, 2019 by averaging the active community counts at August 31, 2019 and May 31, 2019.

	Three months ended August 31,	
	2020	2019
Average sales price per home closed (in thousands):		
Entry-Level - Starlight Homes	$ 229	$ 218
Entry-Level - Ashton Woods	$ 296	$ 284
Move-up - Ashton Woods	$ 425	$ 422
Multi-Move-Up - Ashton Woods	$ 694	$ 726
Company Average	$ 333	$ 349

During the three months ended August 31, 2020, we closed 1,242 homes. Of those closings, 1,009 (81%) were single-family detached homes, while the remaining 233 (19%) homes closed were single-family attached homes.

During the twelve months ended August 31, 2020, the Company added 76 new active communities, while closing out 71 communities. Of the 76 active communities added during the twelve months ended August 31, 2020, 23 (30%) are considered to be entry-level Starlight Homes, 16 (21%) are considered to be entry-level Ashton Woods Homes, 28 (37%) are considered to be move-up Ashton Woods Homes, and 9 (12%) are considered to be multi-move-up Ashton Woods Homes.

Wholesale home sales, which are 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) to our unaudited condensed consolidated financial statements. The wholesale home sales, which are generally priced at a discount to retail, typically have lower average sales prices than retail home sales. Presented below are certain data for our wholesale home sales:

	Three months ended August 31,	
	2020	2019
Wholesale (units):		
Net new home orders	10	161
Homes closed	48	24
Backlog at end of period	44	137

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 August 31,	
	2020	2019
Revenues:	(in thousands)	
Home sales	$ 413,826	$ 363,434
Land sales	65	—
Financial services and other revenues	9,591	6,735
	$ 423,482	$ 370,169
Gross profit (loss):		
Home sales	$ 78,540	$ 58,258
Land sales	(9)	(28)
Financial services and other revenues	2,388	2,328
	$ 80,919	$ 60,558
Selling, general and administrative	$ 55,287	$ 53,797
Net income (1)	$ 17,750	$ 3,163

(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 $4.0 million and $7.0 million during the three months ended August 31, 2020 and 2019, respectively.

	Three months ended August 31,	
	2020	2019
Supplemental data:	($ in thousands)	
Active communities at end of period	133	128
Net new home orders (in units)	1,903	1,359
Homes closed (in units) (1)	1,242	1,042
Average sales price per home closed	$ 333	$ 349
Backlog at end of period (in units)	2,169	1,625
Sales value of backlog at end of period	$ 812,469	$ 611,769
Home gross margin (2)	19.0 %	16.0 %
Adjusted home gross margin (3)	21.2 %	18.5 %
Ratio of selling, general and administrative expenses to home sales revenue	13.4 %	14.8 %
Interest incurred (4)	$ 15,974	$ 12,963
EBITDA (5)	$ 36,364	$ 17,034
EBITDA margin (5)	8.6 %	4.6 %
Total debt to total capitalization	62.0 %	61.3 %
Total net debt to net capitalization	52.4 %	61.3 %
Cancellation rate (as a percentage of gross sales)(6)	15.8 %	20.3 %

(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 August 31,	
	2020	2019
	(in thousands)	
Home sales revenues	$ 413,826	$ 363,434
Cost of sales homes	335,286	305,176
Home gross margin	78,540	58,258
Add: Inventory impairments - homes	25	384
Interest amortized to cost of sales	9,003	8,743
Adjusted home gross margin	$ 87,568	$ 67,385

(4) Interest incurred for any period is the aggregate amount of interest that is capitalized or charged directly to interest expense during such period. The following table summarizes interest costs incurred, amortized to cost of sales, and expensed during the three months ended August 31, 2020 and 2019:

	Three months ended August 31,	
	2020	2019
	(in thousands)	
Capitalized interest, beginning of period	$ 21,646	$ 19,040
Interest incurred	15,974	12,963
Interest amortized to cost of sales	(9,003)	(8,743)
Interest expensed	(7,429)	(2,776)
Capitalized interest, end of period	$ 21,188	$ 20,484

(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 August 31,	
	2020	2019
	(in thousands)	
Net income	$ 17,750	$ 3,163
Depreciation and amortization	2,182	2,352
Interest amortized to cost of sales	9,003	8,743
Interest expensed	7,429	2,776
EBITDA	$ 36,364	$ 17,034

(6) The following table summarizes the cancellation rates (as a percentage of gross sales) by buyer profile for the three months ended August 31, 2020 and 2019:

	Three months ended August 31,	
	2020	2019
Entry-Level - Starlight Homes	23.6 %	28.9 %
Entry-Level - Ashton Woods	10.4 %	9.1 %
Move-up - Ashton Woods	9.3 %	12.7 %
Multi-Move-Up - Ashton Woods	8.9 %	15.7 %
Consolidated	15.8 %	20.3 %

Results of operations - Segments

We have grouped our homebuilding operating divisions into two reportable segments, east and central. At August 31, 2020, 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 August 31,	
	2020	2019
East:		
Entry-Level - Starlight Homes	329	402
Entry-Level - Ashton Woods	104	38
Move-up - Ashton Woods	164	140
Multi-Move-Up - Ashton Woods	133	71
Total east	730	651
Central:		
Entry-Level - Starlight Homes	430	182
Entry-Level - Ashton Woods	260	141
Move-up - Ashton Woods	438	359
Multi-Move-Up - Ashton Woods	45	26
Total central	1,173	708
Company total	1,903	1,359

Homes closed (units):

	Three months ended August 31,	
	2020	2019
East:		
Entry-Level - Starlight Homes	320	266
Entry-Level - Ashton Woods	70	43
Move-up - Ashton Woods	127	142
Multi-Move-Up - Ashton Woods	76	67
Total east	593	518
Central:		
Entry-Level - Starlight Homes	256	192
Entry-Level - Ashton Woods	125	70
Move-up - Ashton Woods	254	223
Multi-Move-Up - Ashton Woods	14	39
Total central	649	524
Company total	1,242	1,042

Average sales price per home closed:

	Three months ended August 31,	
	2020	2019
	(in thousands)	
East:		
Entry-Level - Starlight Homes	$ 231	$ 217
Entry-Level - Ashton Woods	$ 300	$ 302
Move-up - Ashton Woods	$ 436	$ 467
Multi-Move-Up - Ashton Woods	$ 695	$ 728
Total east	$ 343	$ 360
Central:		
Entry-Level - Starlight Homes	$ 266	$ 218
Entry-Level - Ashton Woods	$ 293	$ 274
Move-up - Ashton Woods	$ 419	$ 393
Multi-Move-Up - Ashton Woods	$ 688	$ 722
Total central	$ 325	$ 337
Company total	$ 333	$ 349

Backlog (units) at end of period:

	As of August 31,	
	2020	2019
East:		
Entry-Level - Starlight Homes	273	315
Entry-Level - Ashton Woods	121	54
Move-up - Ashton Woods	199	180
Multi-Move-Up - Ashton Woods	157	140
Total east	750	689
Central:		
Entry-Level - Starlight Homes	393	133
Entry-Level - Ashton Woods	322	201
Move-up - Ashton Woods	618	559
Multi-Move-Up - Ashton Woods	86	43
Total central	1,419	936
Company total	2,169	1,625

Active communities:

	As of August 31,	
	2020	2019
East:		
Entry-Level - Starlight Homes	16	12
Entry-Level - Ashton Woods	6	5
Move-up - Ashton Woods	14	19
Multi-Move-Up - Ashton Woods	19	16
Total east	55	52
Central:		
Entry-Level - Starlight Homes	15	12
Entry-Level - Ashton Woods	21	14
Move-up - Ashton Woods	37	46
Multi-Move-Up - Ashton Woods	5	4
Total central	78	76
Company total	133	128

Average monthly sales per average active community: [(1)]

	As of August 31,	
	2020	2019
East:		
Entry-Level - Starlight Homes	6.6	10.3
Entry-Level - Ashton Woods	5.0	2.3
Move-up - Ashton Woods	3.4	2.2
Multi-Move-Up - Ashton Woods	2.4	1.5
Total east	4.2	3.9
Central:		
Entry-Level - Starlight Homes	10.2	5.1
Entry-Level - Ashton Woods	4.3	4.3
Move-up - Ashton Woods	3.7	2.6
Multi-Move-Up - Ashton Woods	3.3	1.7
Total central	5.0	3.2
Company total	4.7	3.5

(1) Average active community for the three months ended August 31, 2020 is calculated by averaging the active community counts at August 31, 2020 and May 31, 2020 and for the three months ended August 31, 2019 by averaging the active community counts at August 31, 2019 and May 31, 2019.

The Company presents adjusted home gross margin on a segment basis in the following tables. 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 August 31,	
	2020	2019
Homebuilding East:	(in thousands)	
Home sales revenues	$ 203,141	$ 186,626
Cost of sales homes	170,722	160,605
Home gross margin	32,419	26,021
Add: Inventory impairments	—	343
Interest amortized to cost of sales	5,245	5,251
Adjusted home gross margin	$ 37,664	$ 31,615
Ratio of home gross margin to home sales revenues	16.0 %	13.9 %
Ratio of adjusted home gross margin to home sales revenues	18.5 %	16.9 %

	Three months ended August 31,	
	2020	2019
Homebuilding Central:	(in thousands)	
Home sales revenues	$ 210,685	$ 176,808
Cost of sales homes	164,564	144,571
Home gross margin	46,121	32,237
Add: Inventory impairments	25	41
Interest amortized to cost of sales	3,758	3,492
Adjusted home gross margin	$ 49,904	$ 35,770
Ratio of home gross margin to home sales revenues	21.9 %	18.2 %
Ratio of adjusted home gross margin to home sales revenues	23.7 %	20.2 %

Results of operations - Discussion

Three months ended August 31, 2020 Compared to Three months ended August 31, 2019

Home sales revenues - Consolidated

Home sales revenues increased 13.9% ($50.4 million) for the three months ended August 31, 2020, to $413.8 million from $363.4 million for the three months ended August 31, 2019. The increase in revenues for the three months ended August 31, 2020, as compared to the three months ended August 31, 2019, 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 increased 19.2% (200 homes) for the three months ended August 31, 2020 to 1,242 from 1,042 for the three months ended August 31, 2019. The increase in closings was primarily due to an increase in the number of active communities, particularly the number of entry-level active communities, which typically have higher sales paces, as well as an increase in the average monthly sales per average active communities across most of our buyer profiles. The number of active communities increased from 128 at August 31, 2019 to 133 at August 31, 2020, which included 43 entry-level active communities at August 31, 2019 and 58 entry-level active communities at August 31, 2020. The consolidated average monthly sales per average active community increased from 3.5 average monthly sales per average active community in the three months ended August 31, 2019 to 4.7 average monthly sales per average active community in the three months ended August 31, 2020.

The average sales price of homes closed decreased 4.6% for the three months ended August 31, 2020 to an average of $333,000 from an average of $349,000 for the three months ended August 31, 2019. The decrease in the average sales price of homes closed on a consolidated basis for the three months ended August 31, 2020, compared to the three months ended August 31, 2019, primarily reflected our continued, planned shift toward communities with lower average sales prices. For the three months ended August 31, 2020, 771 closings (62.1%) were from entry-level communities, with generally lower average sales prices, compared to 571 closings (54.8%) for the three months ended August 31, 2019. Notwithstanding the shift to lower price communities, due to the strong demand for new homes, we were able to raise prices and reduce incentives in certain communities across all of our markets, which resulted in increased average sales prices for our entry-level product on a consolidated basis.

Home sales revenues - East segment

Home sales revenues for the east segment increased by 8.8% ($16.5 million) for the three months ended August 31, 2020, to $203.1 million from $186.6 million for the three months ended August 31, 2019. The increase in revenues for the three months ended August 31, 2020, as compared to the three months ended August 31, 2019, 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 months ended August 31, 2020 increased 14.5% (75 homes) as compared to the three months ended August 31, 2019. The average sales price of homes closed decreased 4.7% in the three months ended August 31, 2020 to an average of $343,000 from an average of $360,000 for the three months ended August 31, 2019. The increase in closings was primarily due to an increase in the number of active communities, particularly the number of entry-level active communities, which typically have higher sales paces, as well as an increase in the average monthly sales per average active community. The total number of active communities in the East segment increased to 55 at August 31, 2020 from 52 at August 31, 2019. In addition, the average monthly sales per average active community increased from 3.9 for the three months ended August 31, 2019 to 4.2 for the three months ended August 31, 2020.

The decrease in the average sales price of homes closed for the three months ended August 31, 2020, compared to the three months ended August 31, 2019, was primarily due to the continued, planned shift toward 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 months ended August 31, 2020, 390 (65.8%) of the homes closed were considered entry-level, compared to 309 (59.7%) for the three months ended August 31, 2019. Notwithstanding the shift to lower price communities, due to the strong demand for new homes, we were able to raise prices and reduce incentives in certain communities across all of our markets, which resulted in increased average sales prices for our entry-level product.

Home sales revenues - Central segment

Home sales revenues for the central segment increased by 19.2% ($33.9 million) for the three months ended August 31, 2020 to $210.7 million from $176.8 million for the three months ended August 31, 2019. The increase in revenues for the three months ended August 31, 2020, as compared to the three months ended August 31, 2019, 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 months ended August 31, 2020 increased 23.9% (125 homes) as compared to the three months ended August 31, 2019. The average sales price of homes closed decreased 3.6% in the three months ended August 31, 2020 to an average of $325,000 from an average of $337,000 for the three months ended August 31, 2019. The increase in closings was primarily due to an increase in the number of active communities, particularly the number of entry-level active communities, which typically have higher sales paces, as well as an increase in the average monthly sales per average active community. The number of active communities in the Central segment increased from 76 at August 31, 2019 to 78 at August 31, 2020, which included 26 entry-level active communities at August 31, 2019 and 36 entry-level active communities at August 31, 2020. In addition, the average monthly sales per average active community increased from 3.2 for the three months ended August 31, 2019 to 5.0 for the three months ended August 31, 2020.

The decrease in the average sales price of homes closed during the three months ended August 31, 2020, compared to the three months ended August 31, 2019, 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 and a higher sales pace. During the three months ended August 31, 2020, 381 (58.7%) of the homes closed were considered entry-level, compared to 262 (50.0%) for the three months ended August 31, 2019. Notwithstanding the shift to lower price communities, due to the strong demand for new homes, we were able to raise prices and reduce incentives in certain communities across all of our markets, which resulted in increased average sales prices for our entry-level product.

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 40.0% (544 homes) for the three months ended August 31, 2020 compared to the three months ended August 31, 2019. The increase in net new home orders was primarily due to an increase in the number of active communities, particularly the number of entry-level active communities, which typically have higher sales paces and lower average sales prices, as well as an increase in the average monthly sales per average active community among most of our buyer profiles. The number of active communities increased from 128 at August 31, 2019 to 133 at August 31, 2020, which included 43 entry-level active communities at August 31, 2019 and 58 entry-level active communities at August 31, 2020. The consolidated average monthly sales per average active community increased from 3.5 for the three months ended August 31, 2019 to 4.7 for the three months ended August 31, 2020. Included in the net new home orders are 10 and 161 wholesale home sales to real estate investors for the three months ended August 31, 2020 and 2019, respectively. These homes were sold under bulk sales agreements (see Note 1(j) to our unaudited condensed consolidated financial statements). These sales to resale estate investors are opportunistic in nature and the timing and number of sales can vary from quarter to quarter.

The cancellation rates (as a percentage of gross sales) on our entry-level homes have typically been 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. The largest improvement in cancellation rates for the three months ended August 31, 2020 compared to the three months ended August 31, 2019 was in our Starlight Homes business.

Our backlog consists of homes that are under purchase contracts that have not yet closed. Backlog increased 33.5% from 1,625 homes in backlog at August 31, 2019 to 2,169 homes in backlog at August 31, 2020. The increase in backlog was a result of the Company selling 5,853 homes, which is 544 more homes than were closed (5,309 homes closed) during the twelve months ended August 31, 2020. The sales value of backlog at August 31, 2020 was $812.5 million, a 32.8% increase from the sales value of backlog at August 31, 2019 of $611.8 million. The increase in the sales value of backlog is primarily due to the 33.5% increase in the number of homes in backlog, as discussed above, slightly offset by a decrease in the average sales price of homes in backlog from $376,000 at August 31, 2019 to $375,000 at August 31, 2020. As discussed above, our communities have continued to shift to a higher percentage of entry-level communities. At August 31, 2020, 51.1% of homes (1,109 homes) in backlog (including 44 wholesale home sales) were homes considered to be entry-level, compared to 43.3% (703 homes) at August 31, 2019, (including 137 wholesale home sales). In response to the emergence of COVID-19 as discussed above, the Company slowed and delayed the construction of homes through March and April 2020. This coupled with elongated construction cycle times due to due to the availability and costs of trade labor and building materials, as well as the responsiveness of government services such as zoning, permitting and related government approvals resulted in homes staying in backlog longer than in prior periods.

Net new home orders and backlog - East segment

Net new home orders in the east segment increased 12.1% (79 homes) during the three months ended August 31, 2020 compared to the three months ended August 31, 2019. The increase in net new home orders was largely driven by an increase in the average sales pace per active community for the three months ended August 31, 2020, as compared to the three months ended August 31, 2019 due to the shift in the mix of communities to a higher percentage of entry-level communities, which generally have a higher sales pace. The number of entry-level active communities in the Central segment increased from 17 at August 31, 2019 to 22 at August 31, 2020.

	As of August 31,	
	2020	**2019**
Backlog (units) at end of period:		
Entry-Level - Starlight Homes	273	315
Entry-Level - Ashton Woods	121	54
Move-up	199	180
Multi-Move-Up	157	140
Segment Total	750	689

Backlog consisted of 750 homes at August 31, 2020, which is an 8.9% increase from 689 homes in backlog at August 31, 2019. Included in backlog at August 31, 2020 and August 31, 2019 were 44 and 137 wholesale home sales with real estate investors, respectively. The increase in backlog is a result of selling 61 more homes than we closed during the twelve months ended August 31, 2020. The east segment sold 2,349 homes, while closing 2,288 homes during the twelve months ended August 31, 2020.

The sales value of backlog at August 31, 2020 was $309.5 million, a 15.0% increase compared to the sales value of backlog at August 31, 2019 of $269.1 million, due primarily to an increase in the average sales price of homes in backlog and an increase in the number of homes in backlog. The average sales price of homes in backlog at August 31, 2020 was $413,000 compared to $391,000 at August 31, 2019. The increase 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 750 homes in backlog at August 31, 2020, 394 (52.5%) of the homes were considered entry-level (including 44 wholesale home sales), compared to 369 (53.6%) of the 689 homes in backlog at August 31, 2019 (including 137 wholesale home sales).

Net new home orders and backlog - Central segment

Net new home orders in the central segment increased 65.7% (465 homes) during the three months ended August 31, 2020 compared to the three months ended August 31, 2019. 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 months ended August 31, 2020, as compared to the three months ended August 31, 2019. As discussed above, our strategy has driven a shift in the mix of active communities at August 31, 2020, as compared to August 31, 2019 to a higher percentage of entry-level communities, which typically have a higher rate of sales. The number of entry-level active communities in the Central segment increased from 26 at August 31, 2019 to 37 at August 31, 2020.

	As of August 31,	
	2020	2019
Backlog (units) at end of period:		
Entry-Level - Starlight Homes	393	133
Entry-Level - Ashton Woods	322	201
Move-up	618	559
Multi-Move-Up	86	43
Segment Total	1,419	936

Backlog consisted of 1,419 homes at August 31, 2020, which is a 51.6% increase from 936 homes in backlog at August 31, 2019. The increase in backlog is the result of selling 483 more homes than were closed during the twelve months ended August 31, 2020. The central segment sold 3,504 homes, while closing 3,021 homes during the twelve months ended August 31, 2020.

The sales value of backlog at August 31, 2020 was $503.0 million, a 46.8% increase over the sales value of backlog at August 31, 2019 of $342.7 million due to the 51.6% 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 August 31, 2020 was $354,000 compared to $366,000 at August 31, 2019. 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. Of the 1,419 homes in backlog at August 31, 2020, 715 (50.4%) of the homes were considered entry-level, compared to 334 (35.7%) of the 936 homes in backlog at August 31, 2019. There were not any wholesale homes sales in backlog at August 31, 2020 or August 31, 2019.

Home gross margins - Consolidated

The average gross margin from homes closed for the three months ended August 31, 2020 increased to 19.0% from 16.0% for the three months ended August 31, 2019. The increase in average gross margin for the three months ended August 31, 2020 was due primarily to the shift in community mix toward entry-level communities. We have generally experienced higher demand for our entry level and lower priced homes, while offering fewer incentives, resulting in higher gross margins in our entry-level communities. During the three months ended August 31, 2020, 62.1% of closings were from entry-level communities, compared to 54.8% of closings during the three months ended August 31, 2019. In addition, due to the strong demand for new homes, we were able to raise prices and reduce incentives in certain communities across all of our markets.

Adjusted gross margin from homes closed for the three months ended August 31, 2020 increased to 21.2% from 18.5% for the three months ended August 31, 2019. This increase in the adjusted gross margin was due to the improvement in gross margins as described above, along with an increase in the interest amortized through cost of sales, offset in part by a decrease in impairment charges.

Home gross margins - East segment

The average gross margin from homes closed in the east segment for the three months ended August 31, 2020 increased to 16.0% from 13.9% for the three months ended August 31, 2019. The increase in average gross margin for the three months ended August 31, 2020 as compared to the three months ended August 31, 2019 was due primarily to the shift in community mix to more entry-level communities, which typically have a higher gross margin. During the three months ended August 31, 2020, 65.8% (390 homes) of closings were from entry-level communities compared to 59.7% (309 homes) of closings for the three months ended August 31, 2019.

Home gross margins - Central segment

The average gross margin from homes closed in the central segment for the three months ended August 31, 2020 increased to 21.9% from 18.2% for the three months ended August 31, 2019. The increase in average gross margin for the three months ended August 31, 2020 as compared to the three months ended August 31, 2019 was due primarily to the shift in community mix to more entry-level communities, which typically have a higher gross margin. During the three months ended August 31, 2020, 58.7% (381 homes) of closings were from entry-level communities compared to 50.0%% (262 homes) of closings for the three months ended August 31, 2019.

Selling, general and administrative expenses

SG&A totaled $55.3 million for the three months ended August 31, 2020 compared to $53.8 million for the three months ended August 31, 2019. SG&A as a percentage of home sales revenue decreased to 13.4% for the three months ended August 31, 2020 from 14.8% for the three months ended August 31, 2019. The decrease in SG&A as a percentage of home sales revenue for the three months ended August 31, 2020 as compared to the three months ended August 31, 2019 was primarily related to a decrease in sales and marketing costs as a percentage of revenue due to a reduction in advertising and marketing costs, given the strong demand we are experiencing for new homes across all of our markets, as well as a decrease in salaries and benefits for administrative sales positions. This was partially offset by an increase in sales commissions due to an increase in the number of home closings, as well as an increase in legal settlements and fees incurred in the normal course of business.

Land sales

We periodically elect to sell parcels of land or lots. We had $0.1 million in sales of land and lots during the three months ended August 31, 2020 and no sales of land and lots during the three months ended August 31, 2019.

Net income

Net income increased $14.6 million for the three months ended August 31, 2020 as compared to the three months ended August 31, 2019. The increase in net income for the three months ended August 31, 2020 as compared to the three months ended August 31, 2019 is primarily attributable to an increase in revenues for the three months ended August 31, 2020 as compared to the three months ended August 31, 2019, as a result of the 19.2% increase in the number of homes closed during the three months ended August 31, 2020 as compared to the three months ended August 31, 2019, as well as an increase in home gross margins for the three months ended August 31, 2020 as compared to the three months ended August 31, 2019.

Liquidity and capital resources

We currently fund our operations with proceeds from the sales of homes and land, borrowings under our 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. During the fourth quarter of fiscal 2020, the Company borrowed $250.0 million under the Restated Revolver as a precautionary measure in order to increase its cash position and preserve financial flexibility in light of uncertainty in the global markets resulting from the COVID-19 outbreak. Prior to May 31, 2020, the Company fully repaid the $250.0 million the Company had drawn under its Restated Revolver after a review of its cash and liquidity position. The Company did not access the Restated Revolver to fund operations during the three months ended August 31, 2020 and had no borrowings outstanding under the Restated Revolver as of August 31, 2020. The Company's total liquidity including cash, cash equivalents, and available additional borrowing capacity was $494.9 million as of August 31, 2020.

Operating cash flows

Net cash used in operating activities for the three months ended August 31, 2020 was $4.9 million compared to $75.3 million of net cash used in operating activities for the three months ended August 31, 2019. The primary sources of funds from operations are from the closing of homes. The decrease in net cash used in operations for the three months ended August 31, 2020 was primarily due to our strategic decision to focus on cash generation and preservation, including slowing and delaying construction of homes, delaying openings of new communities, and restructuring and delaying land investments. As home sales regained momentum at the end of April 2020, we strategically started construction on additional homes, opened new communities, made new land investments, and developed lots we own, while continuing to focus on maintaining adequate liquidity through the uncertain times ahead.

Investing cash flows

Net cash used in investing activities was $1.7 million for the three months ended August 31, 2020 and $0.9 million for the three months ended August 31, 2019. Net cash used in investing activities for the three months ended August 31, 2020 was to furnish and/or update furnishings in model homes and sales offices.

Financing cash flows

Net cash used in financing activities was $4.0 million for the three months ended August 31, 2020, compared to $76.1 million of cash provided by financing activities for the three months ended August 31, 2019. The funds used in financing activities during the three months ended August 31, 2020 consisted of (i) distributions of approximately $4.0 million to our Members and (ii) $56.0 thousand of debt issuance costs paid in connection with the issuance of the 6.625% Notes and the amendment to the Restated Revolver. At August 31, 2020, we had no outstanding borrowings under our Restated Revolver and available additional borrowing capacity of $247.2 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 increased to 62.0% at August 31, 2020 from 61.3% at August 31, 2019. 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 52.4% at August 31, 2020 from 61.3% at August 31, 2019.

Inventory

As of August 31, 2020, we had the following owned homes in our reportable segments (in units):

	Homes Under Construction			**Completed Homes**			
	Unsold	**Models**(1)	**Sold**	**Unsold**	**Models**(2)	**Sold**	**Total Homes**
East	387	7	377	125	52	193	1,141
Central	331	6	845	56	72	146	1,456
Company total	718	13	1,222	181	124	339	2,597

(1) Includes 9 models under the Ashton Woods brand name and 4 sales offices under the Starlight Homes brand name.
(2) Includes 92 models under the Ashton Woods brand name and 32 sales offices under the Starlight Homes brand name.

As of August 31, 2020, 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	1,141	1,194	2,033	422	4,790	13,435	18,225
Central	1,456	1,690	1,848	511	5,505	14,802	20,307
Total Company	2,597	2,884	3,881	933	10,295	28,237	38,532
Percentage of total controlled	6.7 %	7.5 %	10.1 %	2.4 %	26.7 %	73.3 %	100.0 %

As of August 31, 2020 and 2019, we had the following unsold homes in inventory (in units):

	As of August 31,	
	2020	2019
Entry-Level - Starlight Homes	373	608
Entry-Level - Ashton Woods	149	124
Move-up	258	509
Multi-Move-Up	119	236
Consolidated	899	1,477

The total number of unsold homes in inventory decreased from 1,477 at August 31, 2019 to 899 at August 31, 2020. As discussed above, the Company made a number of strategic decisions focused on cash generation and preservation in the wake of COVID-19, one of which included a time period during which the Company did not start additional unsold homes. As a result of this decision, as well as the strong demand during the later part of the spring selling season and through the summer selling season, the number of unsold homes in inventory decreased at August 31, 2020 compared to August 31, 2019.

In addition to the 10,295 lots we owned, we controlled, through the use of purchase and option agreements, 28,237 lots at August 31, 2020. Purchase and option agreements that did not require consolidation under ASC 810, ASC 606, or ASC 470-40 at August 31, 2020 had an aggregate remaining purchase price of $1.2 billion. In connection with these agreements, we had cash deposits of $152.0 million at August 31, 2020. In addition, we had purchase and option agreements consolidated under ASC 606 or ASC 470-40 with an aggregate remaining purchase price of $130.2 million and cash deposits of $29.7 million (See Note 4 to our unaudited condensed consolidated financial statements as of August 31, 2020).

During the three months ended August 31, 2020, we acquired 2,021 lots for a total purchase price of $107.6 million. We spent $27.2 million on land development during the three months ended August 31, 2020. We spent $1.7 million during the three months ended August 31, 2020 to furnish and/or update furnishings in model homes and sales offices.

Aggregate contractual commitments and off-balance sheet arrangements

As of August 31, 2020, 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 August 31, 2020, compared to those contained in our audited consolidated financial statements for the year ended May 31, 2020. Our debt obligations are fully discussed in Note 6 to our unaudited condensed consolidated financial statements as of August 31, 2020.

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 August 31, 2020, we had letters of credit and surety bonds outstanding of $0.8 million and $81.3 million, respectively. As of August 31, 2020, we had $49.2 million of unused letter of credit capacity under the Restated Revolver.

On December 13, 2019, the Company issued a $4.7 million note payable to an unaffiliated third party, related to a purchase of land, which matures on July 13, 2022. The note payable has an interest rate of 10.00%. The note is collateralized by the land to which it relates and has no recourse to any other assets or to the Company. As of August 31, 2020, the outstanding note payable balance, including accrued interest, totaled $4.0 million.

At August 31, 2020, we controlled 38,532 lots and homes available to close. Of the 38,532 lots and homes controlled, we owned 26.7%, or 10,295 lots and homes, and 73.3%, or 28,237 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 August 31, 2020, these agreements had an aggregate remaining purchase price of $1.2 billion, net of deposits of $152.0 million. In addition, we had purchase and option agreements recorded under ASC 606 or ASC 470-40 with an aggregate remaining purchase price of $130.2 million and cash deposits of $29.7 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 August 31, 2020, real estate not owned totaled $84.0 million related to eleven lot purchase agreements with $29.7 million of non-refundable deposits. Refer to our discussion in Note 4 to our unaudited condensed consolidated financial statements as of August 31, 2020.

As of August 31, 2020, 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 August 31, 2020, 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 three months ended August 31, 2020, compared with those disclosed in our audited consolidated financial statements for the fiscal year ended May 31, 2020.

Transactions with related parties

See Note 9 to our unaudited condensed consolidated financial statements as of August 31, 2020 for transactions with related parties. The Company is a party to nine 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, 2020 for transactions existing at such date.

Pending accounting pronouncements

See Note 2 to our unaudited condensed consolidated financial statements as of August 31, 2020.

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 August 31, 2020, we had no outstanding borrowings under the Restated Revolver.

Item 4. *Controls and Procedures*

Pursuant to section 4.03 of each of the indentures governing the 6.750% Notes, 9.875% Notes, and 6.625% 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.