

THIS QUARTERLY REPORT IS BEING PREPARED PURSUANT TO REQUIREMENTS CONTAINED IN THE INDENTURE, DATED AS OF FEBRUARY 6, 2013 GOVERNING THE 6.875% SENIOR NOTES DUE 2021 ISSUED BY ASHTON WOODS USA L.L.C. AND IN THE INDENTURE, DATED AS OF AUGUST 8, 2017 GOVERNING THE 6.750% SENIOR NOTES DUE 2025 ISSUED BY ASHTON WOODS USA L.L.C.

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

For the quarterly period ended November 30, 2018

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission file Number: N/A

**Ashton Woods USA L.L.C.**

(Exact Name of Registrant as Specified in Its Charter)

**Nevada**

(State or Other Jurisdiction of Incorporation or Organization)

**37-1590746**

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

**1405 Old Alabama Road Suite 200  
Roswell, GA**

(Address of Principal Executive Offices)

**30076**

(Zip Code)

**(770) 998-9663**

Registrant's telephone number, including area code

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

Title of Each Class

**NONE**

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

Title of Each Class

**NONE**

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Emerging growth company

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

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

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

	<u>PAGE</u>
<b>PART I. FINANCIAL INFORMATION</b>	
<b>Item 1. Unaudited Condensed Consolidated Financial Statements</b>	
<b>Review Report of Independent Auditors</b>	<b>3</b>
<b>Unaudited Condensed Consolidated Balance Sheets</b>	<b>4</b>
<b>Unaudited Condensed Consolidated Statements of Income</b>	<b>5</b>
<b>Unaudited Condensed Consolidated Statements of Members' Equity</b>	<b>6</b>
<b>Unaudited Condensed Consolidated Statements of Cash Flows</b>	<b>7</b>
<b>Notes to Unaudited Condensed Consolidated Financial Statements</b>	<b>9</b>
<b>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</b>	<b>27</b>
<b>Item 3. Quantitative and Qualitative disclosures about market risk</b>	<b>43</b>
<b>Item 4. Controls and Procedures</b>	<b>43</b>
<b>PART II. OTHER INFORMATION</b>	
<b>Item 1. Legal Proceedings</b>	<b>44</b>



Ernst & Young LLP  
Suite 1000  
55 Ivan Allen Jr. Boulevard  
Atlanta, GA 30308

Tel: +1 404 874 8300  
Fax: +1 404 8175589  
ey.com

## Review Report of Independent Auditors

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

We have reviewed the condensed consolidated financial information of Ashton Woods USA L.L.C., which comprise of the condensed consolidated balance sheet as of November 30, 2018, and the related condensed consolidated statements of income for the three- and six-month periods ended November 30, 2018 and 2017, condensed consolidated statements of cash flows for the six-month periods ended November 30, 2018 and 2017, and condensed consolidated statements of members' equity for each of the three-month periods in the period from May 31, 2017 to November 30, 2018.

### Management's Responsibility for the Financial Information

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

### Auditor's Responsibility

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

### Conclusion

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

### Report on Condensed Consolidated Balance Sheet as of May 31, 2018

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, 2018, and the related consolidated statements of income, 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 18, 2018. In our opinion, the accompanying condensed consolidated balance sheet of Ashton Woods USA L.L.C. as of May 31, 2018, is consistent, in all material respects, with the consolidated balance sheet from which it has been derived.

*Ernst & Young LLP*

January 9, 2019

## PART I. FINANCIAL INFORMATION

### Item 1. *Financial Statements*

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

	<b>November 30, 2018</b>	<b>May 31, 2018</b>
<b>Assets:</b>	(Unaudited)	
Cash and cash equivalents	\$ —	\$ 27,496
Restricted cash	44	222
Receivables	20,967	18,575
Inventory	940,073	807,914
Property and equipment, net	14,755	16,316
Investments in unconsolidated entities	7,068	6,866
Deposits on real estate under option or contract	109,023	79,516
Other assets	93,932	105,745
Total assets	<u>\$ 1,185,862</u>	<u>\$ 1,062,650</u>
<b>Liabilities and members' equity:</b>		
<b>Liabilities:</b>		
Accounts payable	\$ 95,731	\$ 65,238
Other liabilities	107,899	127,372
Customer deposits	27,153	29,531
Debt	605,986	492,600
Total liabilities	<u>836,769</u>	<u>714,741</u>
<b>Commitments and contingencies (Note 12)</b>		
<b>Members' equity</b>	349,093	347,909
Total liabilities and members' equity	<u>\$ 1,185,862</u>	<u>\$ 1,062,650</u>

*See accompanying notes to unaudited condensed consolidated financial statements.*

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

	Three months ended November 30,		Six months ended November 30,	
	2018	2017	2018	2017
	(Unaudited)			
<b>Revenues:</b>				
Home sales	\$ 336,340	\$ 312,883	\$ 692,144	\$ 566,970
Land sales	2,239	912	2,314	1,484
Financial services and other revenues	1,253	—	2,750	—
	<u>339,832</u>	<u>313,795</u>	<u>697,208</u>	<u>568,454</u>
<b>Cost of sales:</b>				
Cost of sales homes	278,122	258,826	570,582	468,124
Cost of sales land	1,963	698	2,861	1,272
	<u>280,085</u>	<u>259,524</u>	<u>573,443</u>	<u>469,396</u>
Gross profit	59,747	54,271	123,765	99,058
<b>Other expense (income):</b>				
Selling, general and administrative	47,567	43,075	95,729	83,690
Interest expense	1,817	3,549	3,713	6,940
Depreciation and amortization	2,678	2,744	5,387	5,914
Loss from early extinguishment of debt	—	—	—	5,263
Other income	(326)	(1,818)	(232)	(3,085)
	<u>51,736</u>	<u>47,550</u>	<u>104,597</u>	<u>98,722</u>
Equity in earnings in unconsolidated entities	657	579	1,381	851
Net income	<u>\$ 8,668</u>	<u>\$ 7,300</u>	<u>\$ 20,549</u>	<u>\$ 1,187</u>

*See accompanying notes to unaudited condensed consolidated financial statements.*

**ASHTON WOODS USA L.L.C.**

**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF MEMBERS' EQUITY**

**(In thousands)**

	Class A interest	Class B interests	Class C interests	Total members' equity
<b>Members' equity at May 31, 2017 (Audited)</b>	\$ 115,700	\$ 24,714	\$ 172,789	\$ 313,203
Net loss	(2,379)	(585)	(3,149)	(6,113)
Distributions	(5,195)	(1,277)	(6,878)	(13,350)
<b>Members' equity at August 31, 2017 (Unaudited)</b>	\$ 108,126	\$ 22,852	\$ 162,762	\$ 293,740
Net income	2,841	698	3,761	7,300
<b>Members' equity at November 30, 2017 (Unaudited)</b>	\$ 110,967	\$ 23,550	\$ 166,523	\$ 301,040
Net income	3,070	755	4,066	7,891
Distributions	(315)	(78)	(417)	(810)
<b>Members' equity at February 28, 2018 (Unaudited)</b>	\$ 113,722	\$ 24,227	\$ 170,172	\$ 308,121
Net income	16,886	4,150	22,356	43,392
Distributions	(1,402)	(344)	(1,858)	(3,604)
<b>Members' equity at May 31, 2018 (Audited)</b>	\$ 129,206	\$ 28,033	\$ 190,670	\$ 347,909
Net income	4,623	1,136	6,122	11,881
Distributions	(5,201)	(1,278)	(6,886)	(13,365)
<b>Members' equity at August 31, 2018 (Unaudited)</b>	\$ 128,628	\$ 27,891	\$ 189,906	\$ 346,425
Net income	3,373	829	4,466	8,668
Distributions	(2,335)	(574)	(3,091)	(6,000)
<b>Members' equity at November 30, 2018 (Unaudited)</b>	<u>\$ 129,666</u>	<u>\$ 28,146</u>	<u>\$ 191,281</u>	<u>\$ 349,093</u>

*See accompanying notes to unaudited condensed consolidated financial statements.*

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

	Six months ended November 30,	
	2018	2017
	(Unaudited)	
<b>Cash flows from operating activities:</b>		
Net income	\$ 20,549	\$ 1,187
Adjustments to reconcile net income to net cash used in operating activities:		
Equity in earnings in unconsolidated entities	(1,381)	(851)
Returns on investments in unconsolidated entities	1,348	799
Long-term compensation expense	1,223	1,454
Loss on early extinguishment of debt	—	5,263
Inventory impairments	2,718	47
Depreciation and amortization	5,387	5,914
Changes in operating assets and liabilities:		
Inventory	(134,877)	(124,277)
Receivables	(2,392)	(2,294)
Deposits on real estate under option or contract	(29,507)	(609)
Other assets	13,100	10,865
Accounts payable	30,493	9,110
Other liabilities	(20,890)	(11,614)
Customer deposits	(2,378)	5,577
Net cash used in operating activities	(116,607)	(99,429)
<b>Cash flows from investing activities:</b>		
Returns of investments in unconsolidated entities	25	2,245
Additions to property and equipment	(4,180)	(3,121)
Net cash used in investing activities	(4,155)	(876)
<b>Cash flows from financing activities:</b>		
Borrowings from revolving credit facility	549,000	546,700
Repayments of revolving credit facility	(436,547)	(569,386)
Proceeds from issuance of 6.750% Notes	—	250,000
Payment of debt issuance costs	—	(7,431)
Repayment of 6.875% Notes	—	(100,000)
Payment of premiums on 6.875% Notes	—	(3,820)
Repayment of Notes Payable	—	(2,338)
Members' distributions	(19,365)	(13,350)
Net cash provided by financing activities	93,088	100,375
Change in cash, cash equivalents, and restricted cash	(27,674)	70
<b>Cash, cash equivalents, and restricted cash, beginning of period</b>	<b>27,718</b>	<b>198</b>
<b>Cash, cash equivalents, and restricted cash, end of period</b>	<b>\$ 44</b>	<b>\$ 268</b>
<b>Supplemental cash flow information:</b>		
Cash paid for interest, net of amounts capitalized	\$ 3,790	\$ 5,949

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

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

	As of November 30,	
	2018	2017
Cash and cash equivalents	\$ —	\$ —
Restricted cash	44	268
<b>Total cash, cash equivalents, and restricted cash</b>	<b>\$ 44</b>	<b>\$ 268</b>

*See accompanying notes to unaudited condensed consolidated financial statements.*



**ASHTON WOODS USA L.L.C.**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**November 30, 2018**

**Note 1 — Basis of Presentation and Significant Accounting Policies**

**(a) Operations**

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

Included in the segments are Starlight Homes communities across all of our markets.

The Company offers title services to its homebuyers in its Dallas, San Antonio, Austin, Houston, Orlando, Southwest Florida, Raleigh, 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, and Phoenix 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. Certain reclassifications have been made to the prior year balances to conform to the current year presentation; specifically on the unaudited condensed consolidated statements of cash flows for six months ended 2017, the change in real estate not owned, net, has been reclassified from its own line item to other assets and other liabilities. In the Company's opinion, all adjustments (consisting solely of normal recurring accruals) necessary for a fair presentation of the results for the interim periods presented have been included in the accompanying unaudited condensed consolidated financial statements.

**(c) Cash, cash equivalents, and restricted cash**

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

**(d) Inventory**

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

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

in subsequent months to the amount accrued. Actual costs to be paid on closed homes in the future could differ from the current estimate.

Inventory is stated at cost, unless the carrying amount is determined not to be recoverable, in which case the inventory is written down to fair value in accordance with the Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Subtopic 360-10, *Property, Plant and Equipment*. The Company reviews its inventory in accordance with ASC Subtopic 360-10, which requires long-lived assets to be assessed for impairment when facts and circumstances indicate an impairment may exist. The Company utilizes an undiscounted future cash flow model in this assessment. When the results of the undiscounted future cash flows are less than the carrying value of the community (asset group), an asset impairment must be recognized in the unaudited condensed consolidated financial statements as a component of cost of sales. The amount of the impairment is calculated by subtracting the estimated fair value, less cost to sell, of the community 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, the Company recorded inventory impairment charges of \$2.7 million during the six months ended November 30, 2018 which consisted of \$1.9 million of impairments on homes in inventory and \$0.8 million of impairments on land that was held for sale. The Company recorded inventory impairment charges of \$47,000 on homes in inventory during the six months ended November 30, 2017. As of November 30, 2018, the aggregate fair value of our inventory that was impacted by inventory impairment charges during the six months ended November 30, 2018 was \$10.6 million.

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. If events and circumstances indicate that the carrying value of a real estate asset is not expected to be recoverable, then it is written down to its estimated fair value, less cost to sell. Given the historical variability in the homebuilding industry cycle, the Company is of the view that the valuation of homebuilding inventories is sensitive to changes in economic conditions, such as interest rates, the availability of credit, and unemployment levels. Changes in these economic conditions could materially affect the projected home sales prices, the level of sales incentives, the costs to develop land and construct homes, and the monthly rate of sales. Because of these potential changes in economic and market conditions, in conjunction with the assumptions and estimates required of management in valuing homebuilding inventory, actual results could differ materially from management’s assumptions and may require material inventory impairments to be recorded in the future.

**(e) Receivables**

Receivables at November 30, 2018 and May 31, 2018 consisted of the following (in thousands):

	<b>November 30, 2018</b>	<b>May 31, 2018</b>
Closing funds due	\$ 4,581	\$ 6,890
Land development receivables	7,001	3,957
MUD receivables <sup>(1)</sup>	5,376	3,882
Other receivables <sup>(2)</sup>	4,009	3,846
	<u>\$ 20,967</u>	<u>\$ 18,575</u>

(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 Subtopic 470-40, *Product Financing Arrangements*, or ASC 810, *Consolidation* (see Note 4).

**(g) Investments in unconsolidated entities**

The Company participates in two land development joint ventures in which it has less than a controlling interest. The Company accounts for its interests in these entities under the equity method. The Company's share of profits from lots it purchases from these entities is deferred and treated as a reduction of the cost basis of land purchased from the entity. The Company's share of profits from lots purchased by third parties is recognized immediately and included within equity in earnings in unconsolidated entities in the unaudited condensed consolidated statements of income (see Note 5).

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

Investments in unconsolidated entities are evaluated for other-than-temporary impairment during each reporting period pursuant to ASC Subtopic 323-10, *Investments—Equity Method and Joint Ventures*. A series of operating losses or other factors may indicate an other-than-temporary decrease in the value of the Company's investment in the unconsolidated entity. The amount of impairment recognized is the excess of the investment's carrying value over its estimated fair value. The Company did not recognize any other-than-temporary impairment during the six months ended November 30, 2018 and 2017 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 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 was \$0.7 million and \$1.2 million for the three and six months ended November 30, 2018, respectively, and \$0.1 million and \$0.2 million for the three and six months ended November 30, 2017, respectively.

**(i) Property and equipment**

Property and equipment is recorded at cost. Depreciation 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 life of the lease. Repairs and maintenance costs are expensed as incurred. The Company's property and equipment at November 30, 2018 and May 31, 2018 consisted of the following (in thousands):

	<b>November 30, 2018</b>	<b>May 31, 2018</b>
Office furniture and equipment	\$ 4,062	\$ 4,011
Sales offices, design studios, and model furnishings	39,242	41,102
Leasehold improvements	1,917	1,816
	45,221	46,929
Accumulated depreciation and amortization <sup>(1)</sup>	(30,466)	(30,613)
	<u>\$ 14,755</u>	<u>\$ 16,316</u>

(1) Net of retirements and disposals.

Depreciation and amortization expense approximated \$2.7 million and \$5.4 million for the three and six months ended November 30, 2018, respectively, and \$2.7 million and \$5.9 million for the three and six months ended November 30, 2017, respectively.

**(j) Revenue recognition**

On June 1, 2018, the Company adopted FASB Accounting Standards Update ("ASU") No. 2014-09, *Revenue from Contracts with Customers (Topic 606)* ("ASU 2014-09"). As a result of our adoption of ASU 2014-09, our accounting policies for revenue recognition are as follows:

With respect to home sale revenues, revenue from a home sale is recognized when we have satisfied the performance obligation in the home sales contract, which is generally at the time of the closing of each sale, when title to and possession of the property are transferred to the buyer. The revenue recognized for each home sale includes the base sales price of the home, as well as any purchased options and upgrades and is reduced for any sales price incentives. Our performance obligation to deliver the agreed-upon home is generally satisfied in less than one year from the original contract date. Home sale contract assets consist of cash from home closings in transit or held in escrow for our benefit, which is typically received within two days of the home closing. Home sale contract assets totaled \$4.6 million and \$6.9 million at November 30, 2018 and May 31, 2018, 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 \$27.2 million and \$29.5 million at November 30, 2018 and May 31, 2018, respectively. Of the customer deposit liabilities at May 31, 2018, \$21.4 million was recognized in revenues in the six months ended November 30, 2018 upon the closing of the related homes. The Company's adoption of ASU 2014-09 did not result in a change in the classification of home sale revenues on the unaudited condensed consolidated statements of income. 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. Land sale contract assets and liabilities were immaterial at November 30, 2018 and May 31, 2018. The Company's adoption of ASU 2014-09 did not result in a change in the classification of land sale revenues on the unaudited condensed consolidated statements of income.

Finally, with respect to financial services and other revenues, financial services revenue, which are not within the scope of ASU 2014-09, primarily consist of title premium income earned from the provision of title services for homebuyers. Other revenues primarily consists of revenue from forfeited customer deposits that is recognized upon cancellation of the home sales contract by the customer and other miscellaneous customer revenue that is recognized when the related performance obligation is satisfied. Financial services and other revenues, which are in the scope of ASU 2014-09, were previously classified as other expense/(income) on the unaudited condensed consolidated statements of income, but are now classified as revenue effective June 1, 2018. Financial services and other revenues recognized prior to June 1, 2018 have not been reclassified to revenue on the unaudited condensed consolidated statements of income due to the immateriality of those revenues.

ASU 2014-09 provides certain practical expedients that limit some accounting treatments and disclosure requirements. Accordingly, we do not disclose the value of unsatisfied performance obligations for contracts with an original expected length of one year or less. In addition, the expected revenue to be recognized in any future year relating to unsatisfied performance obligations with an original expected length greater than one year is not material.

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

**(k) Prepaid expenses**

Included in other assets are prepaid expenses of approximately \$6.1 million and \$9.2 million as of November 30, 2018 and May 31, 2018, respectively, which primarily represent prepaid insurance, fees, permits, and rent.

**(l) Warranty costs**

The Company provides its homebuyers with limited warranties that generally provide for ten years of structural coverage, two years of coverage for plumbing, electrical and heating, ventilation and air conditioning systems, and one year of coverage for workmanship and materials. Warranty liabilities are initially established on a per home basis by charging cost of sales and establishing a warranty liability for each home delivered to cover expected costs of materials

and labor during the warranty period. The amounts accrued are based on management's estimate of expected warranty-related costs under all unexpired warranty obligation periods. The Company's warranty liability is based upon historical warranty cost experience in each operating division and is adjusted as appropriate to reflect qualitative risks associated with the types of homes built and the geographic areas in which they are built. The Company's warranty liability is included in other liabilities in the unaudited condensed consolidated balance sheets.

Presented below are summaries of the activity in the Company's warranty liability account for the three and six months ended November 30, 2018 and 2017 (in thousands):

	<b>Three months ended November 30,</b>		<b>Six months ended November 30,</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
Warranty liability, beginning of period	\$ 9,892	\$ 9,114	\$ 10,342	\$ 9,877
Costs accrued during period	2,755	3,088	5,358	5,373
Costs incurred during period	(2,855)	(2,977)	(5,908)	(6,025)
Warranty liability, end of period	<u>\$ 9,792</u>	<u>\$ 9,225</u>	<u>\$ 9,792</u>	<u>\$ 9,225</u>

**(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 \$2.8 million and \$5.1 million for the three and six months ended November 30, 2018, respectively, and \$2.3 million and \$4.6 million for the three and six months ended November 30, 2017, respectively.

**(n) Long-term incentive plan**

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

**(o) Income taxes**

The Company operates as a limited liability company and is treated as a partnership for income tax purposes. Accordingly, the Company incurs no liability for federal or state income taxes, since the taxable income or loss is passed through to its Members, but incurs liabilities for certain state taxes payable directly by the Company. The Company calculates its Members' potential tax liability related to their share of the Company's taxable income and may make distributions to such Members to allow them to satisfy their tax liability, subject to limitations contained in the Company's senior secured revolving credit facility and in the indentures governing its 6.875% Senior Notes due 2021 (the "6.875% Notes") and its 6.750% Senior Notes due 2025 (the "6.750% Notes"). Any tax distributions made to the Members are treated as a reduction of equity. The Company made tax distributions to its Members of \$19.4 million and \$13.4 million during the six months ended November 30, 2018 and 2017, respectively. On December 22, 2017, the U.S. government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the "Tax Act"), which generally takes effect for taxable years after December 31, 2017. The Tax Act makes broad and complex changes to the U.S. tax code that will impact many areas of taxation. As a result of the tax rate changes in the Tax Act, the Company has used a lower effective rate to determine tax distributions beginning in January 2018.

**(p) Use of estimates**

The preparation of unaudited condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States ("GAAP") requires management to make estimates and assumptions that affect

the amounts reported in the unaudited condensed consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

**(q) Segments**

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

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

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

**(r) Subsequent events**

The Company has evaluated subsequent events through January 9, 2019. This date represents the date on which the unaudited condensed consolidated financial statements were available to be issued.

**Note 2 — Pending and Recently Adopted Accounting Pronouncements**

In May 2014, the FASB issued ASU 2014-09, which is a comprehensive new revenue recognition model that replaces most existing revenue recognition guidance. ASU 2014-09 states that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. As discussed in Note 1(j), on June 1, 2018, the Company adopted ASU 2014-09, applying the modified retrospective method to contracts that were not completed as of June 1, 2018. Results for reporting periods beginning after June 1, 2018, are presented under ASU 2014-09, while prior period amounts have not been adjusted and continue to be reported under the previous accounting standards. There was no material impact to revenues or net income as a result of the application of ASU 2014-09 for the six months ended November 30, 2018, and there have not been significant changes to our business processes or systems as a result of implementing the standard. See Note 1(j) for further discussion of the Company's revenue recognition policy under ASU 2014-09.

In February 2016, the FASB issued Accounting Standards Update No. 2016-02, *Leases* (“ASU 2016-02”), which requires, among other things, that lessees recognize the assets and liabilities arising from operating leases on the balance sheet. The effective date of ASU 2016-02 for the Company is for annual periods beginning after December 15, 2018, and for annual and interim periods thereafter. The standard requires a modified retrospective transition approach. The Company is currently evaluating the impact that ASU 2016-02 will have on its consolidated financial statements and related disclosures.

### Note 3 — Inventory

Inventory consisted of the following at November 30, 2018 and May 31, 2018 (in thousands):

	<b>November 30, 2018</b>	<b>May 31, 2018</b>
Homes under construction and finished homes	\$ 676,973	\$ 505,616
Finished lots	191,916	233,432
Land under development	54,254	48,215
Land held for future development	15,559	18,522
Land held for sale	1,361	2,119
Commercial land	10	10
	<u>\$ 940,073</u>	<u>\$ 807,914</u>

The Company capitalizes all interest incurred to the extent its qualifying assets meet or exceed its debt obligations. If qualifying assets are less than the Company's debt obligations, there are limits on the amount of interest that can be capitalized, and the remainder of interest incurred must be directly expensed. The Company directly expensed interest of \$1.8 million and \$3.7 million for the three and six months ended November 30, 2018, respectively, and \$3.5 million and \$6.9 million for the three and six months ended November 30, 2017, respectively, in the unaudited condensed consolidated statements of income.

The following table summarizes interest costs incurred, charged to cost of sales and directly expensed during the three and six months ended November 30, 2018 and 2017 (in thousands):

	<b>Three months ended November 30,</b>		<b>Six months ended November 30,</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
Capitalized interest, beginning of period	\$ 15,545	\$ 12,410	\$ 13,824	\$ 10,813
Interest incurred	11,051	10,862	21,372	20,158
Interest amortized to cost of sales	(6,530)	(5,715)	(13,234)	(10,023)
Interest expensed	(1,817)	(3,549)	(3,713)	(6,940)
Capitalized interest, end of period	<u>\$ 18,249</u>	<u>\$ 14,008</u>	<u>\$ 18,249</u>	<u>\$ 14,008</u>

### Note 4 — Other Assets

Other assets at November 30, 2018 and May 31, 2018 consisted of the following (in thousands):

	<b>November 30, 2018</b>	<b>May 31, 2018</b>
Real estate not owned	\$ 70,907	\$ 81,677
Prepaid expenses	6,074	9,241
Architecture plans	6,801	7,146
Deferred financing fees	2,468	3,060
Pre-acquisition costs	4,425	2,271
Other deposits	3,257	2,350
	<u>\$ 93,932</u>	<u>\$ 105,745</u>

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 Subtopic 810, *Consolidation* ("ASC 810") or ASC Subtopic 470-40, *Product Financing Arrangements* ("ASC 470-40"). In applying these provisions, the Company regularly evaluates its land and lot purchase agreements.

Pursuant to ASC 810, when the Company enters into a purchase agreement to acquire land or lots from an entity and pays a non-refundable deposit, the Company has concluded that a variable interest entity (“VIE”), for which consolidation is required, may be created because it is deemed to have provided subordinated financial support that will absorb some or all of an entity’s expected losses if they occur. For each VIE, the Company assesses whether it is the primary beneficiary of the VIE and thus must consolidate the entity by first determining if it has the ability to control the activities of the VIE that most significantly impact its economic performance. Such activities include, but are not limited to, the ability to determine the budget and scope of land development work, if any; the ability to control financing decisions for the VIE; the ability to acquire additional land into the VIE or dispose of land in the VIE not under contract; and the ability to change or amend the existing purchase contract with the VIE. If the Company is determined not to control such activities, it is not considered the primary beneficiary of the VIE. If it does have the ability to control such activities, it will continue the analysis by determining if it is expected to absorb a potentially significant amount of the VIE’s losses or, if no party absorbs the majority of such losses, if it will benefit from potentially a significant amount of the VIE’s expected gain. If the Company determines that it is the primary beneficiary of the VIE, it will consolidate the VIE in its financial statements and reflect such assets as “Real estate not owned” and the related liabilities as “Liabilities related to real estate not owned.” At November 30, 2018 and May 31, 2018, no purchase contracts or investments in unconsolidated entities were determined to require consolidation under ASC 810.

Pursuant to ASC 470-40, if a buying entity participates in an arrangement in which it is economically compelled to purchase land, then the entity is required to consolidate such an arrangement. From time to time, the Company enters into arrangements in which it identifies lots that it desires to purchase, finds an investor to purchase the lots and then enters into option purchase agreements to acquire the lots in staged takedowns. In consideration for such options, the Company generally makes nonrefundable deposits. While the Company is generally not obligated to purchase the lots that are the subject of such agreements, it would forfeit the remaining deposits if the lots are not purchased. Although the Company is not obligated to purchase the lots under option unless it enters into a contract with specific performance obligations, if, at the reporting date, the Company believes that due to the terms of the purchase contracts it is compelled to purchase the lots under option, the Company will record “Real estate not owned” and the related liabilities as “Liabilities related to real estate not owned” in connection with such option purchase agreements. The Company has entered into two lot purchase agreements with two separate unaffiliated investor groups and has accounted for them pursuant to ASC 470-40. At November 30, 2018 and May 31, 2018, the Company recorded real estate not owned of \$39.5 million and \$51.1 million, respectively, related to the lot purchase agreements 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 paragraph 606-10-55-70, if the entity will repurchase the lots for an amount that is equal to or more 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.” These option agreements contain no specific performance obligations. At November 30, 2018 and May 31, 2018, the Company recorded real estate not owned of \$31.4 million and \$30.5 million, respectively, for the sale of lots because its repurchase agreements related to this real estate were considered to be financing arrangements.

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 for the senior secured revolving credit facility. Deferred financing fees are amortized as interest over the terms of the related financing arrangement using the effective interest method. The Company did not incur any deferred financing fees during the six months ended November 30, 2018. The Company incurred deferred financing fees during the six months ended November 30, 2017 of \$2.2 million 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 November 30, 2018, the Company participated in two such land joint ventures. The Company's partners in such joint ventures are both related parties and unrelated parties, including homebuilders, land developers or other real estate entities. The partners generally share profits and losses in accordance with their ownership interests. The Company accounts for its interests in these entities under the equity method.

As of November 30, 2018, the Company had equity investments of less than 50% in each of its two land joint ventures and did not have a controlling interest in these unconsolidated entities. The Company and/or its land joint venture partners will typically enter into lot purchase agreements that permit the Company and/or its joint venture partners 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 Company's share of the unconsolidated entity's earnings on the sale of lots to other parties is recognized at the time of the sale.

One of the Company's land joint ventures is 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 that is accounted for under the equity method. As of November 30, 2018, the Company had recorded \$5.6 million for its investment in this unconsolidated entity in the unaudited condensed consolidated balance sheet. The Company entered into a services agreement with the joint venture to provide accounting and administrative services to the joint venture. The Company receives a monthly fee of \$6,000 for these services that is included in other income in the unaudited condensed consolidated statements of income. The Company is a party to a lot purchase agreement with the joint venture, which required a 10% deposit, and has no specific performance requirements for the Company. As of November 30, 2018, the total purchase price of lots remaining to be purchased under this agreement was approximately \$10.9 million. As of November 30, 2018, the joint venture had no debt outstanding.

During the year ended May 31, 2017, the Company offered title services to its homebuyers in its Houston operating division through ownership in a title joint venture. The joint venture ceased operations during the six months ended November 30, 2017, and completed the wind down of its operations during the six months ended November 30, 2018. The Company had an ownership interest of 49% in the joint venture, which was managed by the majority owner with whom the underwriting risks associated with the title insurance resided.

The Company offers residential mortgage services to its homebuyers and the public at large in Austin, Dallas, Houston, San Antonio, and Phoenix through a mortgage joint venture. The Company has an ownership percentage of 49% in this joint venture and has accounted for it under the equity method. The debt of the mortgage joint venture is non-recourse to the Company.

Summarized unaudited financial information related to unconsolidated entities that are accounted for using the equity method as of November 30, 2018 and May 31, 2018 and for the three and six months ended November 30, 2018 and 2017 was as follows (in thousands):

	<b>November 30, 2018</b>	<b>May 31, 2018</b>
Assets:		
Cash	\$ 3,554	\$ 3,428
Mortgage notes receivable	17,314	25,089
Real estate	13,049	15,750
Other	585	914
Total assets	<u>\$ 34,502</u>	<u>\$ 45,181</u>
Liabilities and equity:		
Liabilities:		
Accounts payable and other accruals	\$ 3,087	\$ 3,637
Notes payable <sup>(1)</sup>	16,904	27,386
Total liabilities	19,991	31,023
Equity	14,511	14,158
Total liabilities and equity	<u>\$ 34,502</u>	<u>\$ 45,181</u>

(1) The notes payable balance at November 30, 2018 includes \$16.9 million outstanding on two warehouse lines. The notes payable balance at May 31, 2018 includes \$24.4 million outstanding on two warehouse lines and \$2.9 million of secured debt that is non-recourse to the Company.

	<b>Three months ended November 30,</b>		<b>Six months ended November 30,</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
Revenues:				
Lot sales	\$ 2,850	\$ 3,140	\$ 5,681	\$ 6,731
Financial services	2,299	1,706	4,738	2,760
Total revenues	<u>5,149</u>	<u>4,846</u>	<u>10,419</u>	<u>9,491</u>
Gross profit	<u>2,012</u>	<u>1,729</u>	<u>4,068</u>	<u>3,003</u>
General and administrative expenses:				
Lot sales	4	6	10	44
Financial services	412	312	832	561
Total general and administrative expenses	<u>416</u>	<u>318</u>	<u>842</u>	<u>605</u>
Net earnings	<u>\$ 1,596</u>	<u>\$ 1,411</u>	<u>\$ 3,226</u>	<u>\$ 2,398</u>

## Note 6 — Debt

Debt at November 30, 2018 and May 31, 2018 consisted of the following (in thousands):

	<b>November 30, 2018</b>	<b>May 31, 2018</b>
6.875% Notes <sup>(1)</sup>	\$ 247,744	\$ 247,209
6.750% Notes <sup>(2)</sup>	245,789	245,391
Senior secured revolving credit facility	112,453	—
	<u>\$ 605,986</u>	<u>\$ 492,600</u>

(1) Net of \$1.5 million and \$1.9 million of unamortized deferred financing costs and \$0.8 million and \$0.9 million of unamortized discount as of November 30, 2018 and May 31, 2018, respectively.

(2) Net of \$4.2 million and \$4.6 million of unamortized deferred financing costs as of November 30, 2018 and May 31, 2018, respectively.

### Debt Transactions

On August 8, 2017, the Company and its wholly owned subsidiary, Ashton Woods Finance Co., issued and sold \$250.0 million aggregate principal amount of their 6.750% Notes through a private placement to qualified institutional buyers pursuant to Rule 144A and Regulation S, promulgated 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 net proceeds of the 6.750% Notes were used by the Company to (i) pay the purchase price to the holders of an aggregate of \$100 million principal amount of 6.875% Notes tendered in a tender offer launched by the Company and Ashton Woods Finance Co. for up to \$100.0 million principal amount of 6.875% Notes (the "Tender Offer"), (ii) to repay a portion of the indebtedness outstanding under the Company's senior secured revolving credit facility, and (iii) pay accrued and unpaid interest and prepayment premiums payable on any of the foregoing.

The Company recorded a \$5.3 million loss on the early extinguishment of debt during the six months ended November 30, 2017, comprised of a write-off of \$1.0 million of unamortized deferred financing fees related to the 6.875% Notes, \$0.5 million of unamortized original issue discount on the 6.875% Notes, and the payment of \$3.8 million in repayment premiums. The Company incurred deferred financing fees during the six months ended November 30, 2017 of \$5.2 million related to the issuance of the 6.750% Notes.

### The 6.875% Notes

On August 18, 2017, pursuant to the Tender Offer, the Company purchased \$100.0 million aggregate principal of the Company's then issued and outstanding \$350 million principal amount of 6.875% Notes with the proceeds from the issuance of the 6.750% Notes, as discussed above and below. At November 30, 2018, 6.875% Notes in the aggregate principal amount of \$250 million were outstanding.

The 6.875% Notes mature on February 15, 2021. Interest is payable on the 6.875% Notes on February 15 and August 15 of each year. The 6.875% 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 6.875% 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 6.875% 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 6.875% Notes, with the exception of AW Mortgage Holdings L.L.C., which has been designated an Unrestricted Subsidiary pursuant to the indenture governing the 6.875% Notes.

The indenture governing the 6.875% Notes gives the Company the option to redeem the 6.875% Notes at any time or from time to time, in whole or in part, (a) until February 15, 2019, at certain redemption prices set forth in the indenture governing the 6.875% Notes together with accrued and unpaid interest thereon, if any, to and excluding the redemption date, and (b) on or after February 15, 2019, 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 6.875% Notes contains a number of covenants, including covenants relating to the following:

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

As of November 30, 2018, the Company was in compliance with the covenants in the indenture governing the 6.875% Notes.

### ***The 6.750% Notes***

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

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

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

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

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

As of November 30, 2018, the Company was in compliance with the covenants in the indenture governing the 6.750% Notes.

### ***Senior Secured Revolving Credit Facility***

On June 23, 2017, the Company amended its senior secured revolving credit facility by entering into its First 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 \$45.0 million available for the issuance of letters of credit and a \$10.0 million swingline facility, and with an accordion feature to permit the size of the facility to be increased in the future up to \$400.0 million (dependent upon Company needs and available lender commitments), (ii) a maturity date of December 31, 2020, (iii) modification of certain covenants, and (iv) an increase in the borrowing base advance rates and restating the agreement to reflect such changes. The Restated Revolver limits the principal amount of the aggregate commitment available at any time to the amount that is permitted by the indentures governing the Company's 6.750% Notes and 6.875% Notes, which is 30% of Consolidated Tangible Assets, as defined therein.

Interest accrues on borrowings under the Restated Revolver at the London Interbank Offered Rate (LIBOR) plus an applicable margin that ranges from 305 to 375 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 305 to 375 basis points if not secured by cash. The Restated Revolver has a maturity date of December 31, 2020, subject to an extension in accordance with the terms set forth therein. The Restated Revolver is secured by a continuing first priority security interest in the real property of certain operating divisions selected by the Company for inclusion in the borrowing base, and the personal property of the Company and its subsidiaries affixed to, placed upon, used in connection with, arising from or appropriated for use on the pledged real property and the continuing guarantee of substantially all of its subsidiaries. The Company may pledge additional collateral as needed to increase the borrowing base consistent with the maximum availability under the Restated Revolver.

The Restated Revolver contains the following material financial covenants:

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

Availability under the Restated Revolver is based upon a borrowing base formula. The Restated Revolver contains other affirmative and negative covenants in addition to the financial covenants noted above. The Restated Revolver permits sales and transfers of ownership interests in the Company so long as no change of control, as defined in the Restated Revolver, occurs and permits certain tax distributions to Members and permits certain other distributions to Members if certain Leverage Ratio and other conditions are met. As of November 30, 2018, the Company was in compliance with the covenants in the Restated Revolver.

At November 30, 2018, there was \$112.5 million outstanding under the Restated Revolver and \$7.1 million of letters of credit outstanding. As of November 30, 2018, the Company had available additional borrowing capacity of \$127.7 million under the Restated Revolver based on outstanding borrowings on the Restated Revolver, outstanding letters of credit, the value of collateral pledged to secure the facility, and the borrowing base formula.

#### Note 7 — Other Liabilities

Other liabilities at November 30, 2018 and May 31, 2018 consisted of the following (in thousands):

	<b>November 30, 2018</b>	<b>May 31, 2018</b>
Liabilities related to real estate not owned <sup>(1)</sup>	\$ 46,412	\$ 59,303
Salaries, bonuses and benefits	14,490	24,670
Accrued interest	11,558	11,401
Warranty accruals	9,792	10,342
Accrued long-term compensation	5,014	6,316
Accrued real estate taxes	4,827	3,129
Other	15,806	12,211
	<b>\$ 107,899</b>	<b>\$ 127,372</b>

(1) Net of deposits of \$24.5 million and \$22.4 million as of November 30, 2018 and May 31, 2018, respectively.

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

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

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

At November 30, 2018, there were 20,628,729 membership interests outstanding, comprised as follows:

	<b>Membership Interests</b>	<b>Ownership percentage</b>	<b>Percentage of membership class</b>
<b>Little Shots Nevada L.L.C.</b>			
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%
<b>Total Little Shots Nevada L.L.C.</b>	<b>18,116,595</b>	<b>87.82%</b>	
<b>Various Holders</b>			
Class B	50,649	0.25%	2.57%
Class C	2,461,485	11.93%	23.16%
	<b>20,628,729</b>	<b>100.00%</b>	

## 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 fees of \$800 per home closing quarterly, in arrears, for these services, which are included in selling, general and administrative expenses in the unaudited condensed consolidated statements of income. The Company incurred fees of \$0.7 million and \$1.4 million during the three and six months ended November 30, 2018, respectively, and \$0.6 million and \$1.1 million during the three and six months ended November 30, 2017, respectively, under the services agreement. As of November 30, 2018 and 2017, the balance due to the Investors was \$0.7 million and \$0.6 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 8,000 square feet of commercial space in Dallas, Texas. The initial term of the lease was 66 months, with 25 months remaining as of November 30, 2018. The Company has the option to renew the lease for one additional five-year term. Total minimum lease payments due under the lease were \$0.2 million and \$0.3 million as of November 30, 2018 and 2017, respectively.

### *Lot purchase agreements*

The Company is a party to six lot purchase agreements with the Investors. A deposit of 10% to 15% was required under each of the purchase agreements, and there are no specific performance requirements for the Company. Three of these lot purchase agreements are required to be recorded as real estate not owned in the unaudited condensed consolidated

balance sheets. As of November 30, 2018, the total purchase price of lots remaining to be purchased under such agreements was approximately \$19.2 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 78 lots. A 10% deposit was required under the purchase agreement and there are no specific performance requirements for the Company. As of November 30, 2018, the total purchase price of lots remaining to be purchased was \$10.9 million. As of November 30, 2018, the joint venture had no debt outstanding.

#### *Offsite road improvements agreement*

During the year ended May 31, 2016, the Company entered into a joint development agreement with an affiliate of the Company's largest minority equity holder for the construction of offsite road improvements adjacent to a land parcel. The Company is paid a fee for the oversight of the improvements. Work commenced during the year ended May 31, 2017. Through November 30, 2018, the Company has been paid \$0.2 million under this agreement.

#### **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 2018, the Board of Directors awarded outstanding performance shares to the Company's executive officers, and certain members of the corporate and operating division senior management teams.

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

The following table represents a rollforward of the outstanding performance shares for the six months ended November 30, 2018:

	<b>Full-value shares</b>	<b>Appreciation- only shares</b>	<b>Total shares</b>
Outstanding performance shares as of May 31, 2018	201,597	541,253	742,850
Performance shares awarded during the period	87,537	175,074	262,611
Shares forfeited during the period	(5,617)	(11,234)	(16,851)
Fully vested performance shares paid	(50,540)	(85,393)	(135,933)
Total outstanding performance shares as of November 30, 2018	232,977	619,700	852,677
Total vested performance shares as of November 30, 2018	90,480	334,708	425,188

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

The total number of performance shares vested as of November 30, 2018 and May 31, 2018 was 425,188 and 504,004, respectively. The Company recorded \$0.4 million and \$1.2 million for the three and six months ended November 30, 2018, respectively, and \$0.9 million and \$1.5 million for the three and six months ended November 30, 2017, respectively, in compensation expense associated with the full-value and appreciation-only performance shares. For the six months ended November 30, 2018 and 2017, \$2.5 million (135,933 units) and \$1.5 million (78,068 units), respectively, of vested performance shares were paid out to employees. As of November 30, 2018 and May 31, 2018, the Company's liability for the performance shares was \$5.0 million and \$6.3 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:

<b>Unobservable Inputs:</b>	<b>2018</b>
Average selling price	\$312,000 - \$797,000
Annual discount rate	12%

The following table presents the carrying amounts and estimated fair values of the Company's 6.750% Notes and 6.875% Notes at November 30, 2018 and May 31, 2018:

	<b>Fair Value Hierarchy</b>	<b>November 30, 2018</b>		<b>May 31, 2018</b>	
		<b>Carrying Amount</b>	<b>Fair Value</b>	<b>Carrying Amount</b>	<b>Fair Value</b>
(in thousands)					
<b>Liabilities:</b>					
6.750% Notes	Level 2	\$ 245,789	\$ 226,875	\$ 245,391	\$ 238,750
6.875% Notes	Level 2	247,744	243,750	247,209	251,250
		<u>\$ 493,533</u>	<u>\$ 470,625</u>	<u>\$ 492,600</u>	<u>\$ 490,000</u>

The Company's 6.750% Notes and 6.875% 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 and 6.875% Notes reflect their face amount, adjusted for any unamortized debt issuance costs and discount. The fair values of the 6.750% Notes and 6.875% Notes are derived from quoted market prices by independent dealers (Level 2).

#### **Note 12 — Commitments and Contingencies**

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

In addition, on June 27, 2016, FCC Marsh, LLC (the "Seller") filed a complaint against the Company in the Circuit Court for Collier County, Florida, alleging that the Company breached a lot purchase agreement that provided the Seller with a specific performance right against the Company, subject to certain conditions, by allegedly failing to close on certain lot purchases. The Seller dismissed its claim for specific performance, and seeks declaratory relief and damages. The Company filed a counterclaim seeking declaratory relief, return of the earnest money deposit, foreclosure of the mortgage that secures that deposit, and damages for the Seller's breach of a lease agreement between the parties. While it is premature to predict the ultimate outcome of these proceedings, the Company intends to vigorously defend the lawsuit and pursue its claims against the Seller.

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

In the normal course of business, the Company provides letters of credit and surety bonds to third parties to secure performance and provide deposits under various contracts and commitments. At November 30, 2018 and May 31, 2018, the Company had letters of credit outstanding of \$7.1 million and \$5.3 million, respectively, and surety bonds outstanding

of \$43.7 million and \$31.3 million, respectively. As of November 30, 2018, the Company had \$37.9 million of unused letter of credit capacity under the Restated Revolver.

The Company enters into various option purchase agreements to acquire land. In connection with such agreements, as of November 30, 2018, the Company has made nonrefundable deposits of \$129.5 million, which includes \$24.5 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 \$961.2 million as of November 30, 2018.

### Note 13 — Information on Segments

The Company's homebuilding reportable segments are as follows:

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

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

	Three months ended November 30,		Six months ended November 30,	
	2018	2017	2018	2017
<b>Revenues:</b>				
Homebuilding:				
East	\$ 190,800	\$ 155,628	\$ 383,136	\$ 278,152
Central	145,540	157,255	309,008	288,818
Total revenues	\$ 336,340	\$ 312,883	\$ 692,144	\$ 566,970
<b>Gross profit <sup>(1)</sup>:</b>				
Homebuilding:				
East	\$ 31,875	\$ 26,176	\$ 64,041	\$ 47,404
Central	26,343	27,881	57,521	51,442
Total gross profit	\$ 58,218	\$ 54,057	\$ 121,562	\$ 98,846
<b>Depreciation and amortization:</b>				
East	\$ 1,386	\$ 1,141	\$ 2,647	\$ 2,634
Central	1,254	1,522	2,664	3,120
Total depreciation and amortization	\$ 2,640	\$ 2,663	\$ 5,311	\$ 5,754
<b>Equity in earnings in unconsolidated entities:</b>				
East	\$ (2)	\$ —	\$ (2)	\$ —
Central	659	579	1,383	851
Total equity in earnings in unconsolidated entities	\$ 657	\$ 579	\$ 1,381	\$ 851
<b>Net income:</b>				
East	\$ 5,638	\$ 3,587	\$ 10,791	\$ 3,284
Central	4,807	7,262	13,279	10,255
	10,445	10,849	24,070	13,539
Other <sup>(2)</sup>	(1,777)	(3,549)	(3,521)	(12,352)
Total net income	\$ 8,668	\$ 7,300	\$ 20,549	\$ 1,187

(1) Includes inventory impairments totaling \$1.3 million and \$0.6 million for the east segment and central segment, respectively, during the six months ended November 30, 2018.

(2) "Other" primarily consists of interest directly expensed and a loss from the early extinguishment of debt.

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

	<b>November 30, 2018</b>	<b>May 31, 2018</b>
<b>Assets:</b>		
Homebuilding:		
East	\$ 696,967	\$ 571,861
Central	481,735	430,920
	<u>1,178,702</u>	<u>1,002,781</u>
Other <sup>(1)</sup>	7,160	59,869
Total assets	<u>\$ 1,185,862</u>	<u>\$ 1,062,650</u>

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

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

	<b>Three months ended November 30,</b>		<b>Six months ended November 30,</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
<b>Additions to property and equipment:</b>				
Homebuilding:				
East	\$ 1,342	\$ 1,059	\$ 2,200	\$ 1,842
Central	1,020	123	1,980	920
	<u>2,362</u>	<u>1,182</u>	<u>4,180</u>	<u>2,762</u>
Other <sup>(1)</sup>	—	337	—	359
Total additions to property and equipment	<u>\$ 2,362</u>	<u>\$ 1,519</u>	<u>\$ 4,180</u>	<u>\$ 3,121</u>

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

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

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

### **Forward-Looking Statements**

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

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

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

- Reversal of homebuilding recovery or decline in economic conditions;
- Fluctuations in mortgage interest rates and the availability of mortgage financing;
- The availability of high quality undeveloped land and improved lots at suitable prices;
- The volatility of the capital markets and the banking industry;
- An ownership change which could have unfavorable implications for our debt instruments;
- The availability of qualified employees, skilled labor, qualified subcontractors, and raw materials;
- The competitive nature of the homebuilding industry;
- Deterioration of the economic climate either nationally or in the regions in which we operate, which could impact growth and expansion opportunities, impact the price of labor and materials, impact the value of our inventory, impact inflation, consumer confidence, and consumer preferences;
- Government regulatory and other actions, which could affect tax laws, including laws designed to incentivize home ownership, and could result in delays or increased costs in obtaining necessary permits and complying with environmental laws;
- Timing of permits and other regulatory approvals;
- Our substantial indebtedness and our ability to comply with the related financial and other covenants and our ability to obtain replacement financing as these instruments mature;
- The cost and availability of insurance and the level of warranty claims;
- Cybersecurity attacks and/or threats;
- Judgments or other costs and exposure with respect to litigation and claims;
- Changes in accounting guidelines or our interpretation of those guidelines;
- Adverse weather conditions and acts of war or terror; and
- Other factors, including those discussed elsewhere in our annual report on Form 10-K for the fiscal year ended May 31, 2018, and over which the Company has little or no control.

## Overview

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

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

	Three months ended November 30,		Six months ended November 30,	
	2018	2017	2018	2017
<b>Net new home orders (units):</b>				
Entry-Level - Starlight Homes	232	156	459	306
Entry-Level - Ashton Woods	96	86	271	178
Move-up	310	384	705	792
Multi-Move-Up	78	142	157	293
Company Total	<u>716</u>	<u>768</u>	<u>1,592</u>	<u>1,569</u>

<b>Homes closed (units):</b>				
Entry-Level - Starlight Homes	254	107	513	187
Entry-Level - Ashton Woods	150	78	264	158
Move-up	386	436	736	816
Multi-Move-Up	110	133	272	225
Company Total	<u>900</u>	<u>754</u>	<u>1,785</u>	<u>1,386</u>

<b>Average sales price per home closed (in thousands):</b>				
Entry-Level - Starlight Homes	\$ 216	\$ 209	\$ 214	\$ 210
Entry-Level - Ashton Woods	\$ 302	\$ 287	\$ 303	\$ 287
Move-up	\$ 404	\$ 416	\$ 407	\$ 412
Multi-Move-Up	\$ 732	\$ 648	\$ 746	\$ 654
Company Total	<u>\$ 374</u>	<u>\$ 415</u>	<u>\$ 388</u>	<u>\$ 409</u>

	As of November 30,	
	2018	2017
<b>Backlog (units) at end of period:</b>		
Entry-Level - Starlight Homes	218	181
Entry-Level - Ashton Woods	252	191
Move-up	624	804
Multi-Move-Up	240	377
Company Total	<u>1,334</u>	<u>1,553</u>

	As of November 30,	
	2018	2017
<b>Active communities:</b>		
Entry-Level - Starlight Homes	20	11
Entry-Level - Ashton Woods	12	12
Move-up	68	83
Multi-Move-Up	26	36
Company Total	<u>126</u>	<u>142</u>

	Three months ended November 30,		Six months ended November 30,	
	2018	2017	2018	2017
<b>Monthly sales per average active communities: <sup>(1)</sup></b>				
Entry-Level - Starlight Homes	4.3	5.2	4.3	5.1
Entry-Level - Ashton Woods	2.6	2.3	3.6	2.4
Move-up	1.4	1.6	1.6	1.6
Multi-Move-Up	1.0	1.3	1.0	1.3
Company Total	<u>1.9</u>	<u>1.8</u>	<u>2.1</u>	<u>1.9</u>

(1) For the three months ended November 30th, average active communities is calculated using the average of the August 31st and November 30th quarter ended active community numbers. For the six months ended November 30th, average active communities is calculated using the average of the May 31st and November 30th quarter ended active community numbers.

During the six months ended November 30, 2018, we closed 1,785 homes. Of those closings, 1,518 (85%) were single-family detached product, while the remaining 267 (15%) of the homes closed were single-family attached product.

During the twelve months ended November 30, 2018, the Company added 38 new active communities, while closing out 54 communities. Of the 38 active communities added during the twelve months ended November 30, 2018, 17 are considered to be entry-level.

## Results of operations

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

	Three months ended November 30,		Six months ended November 30,	
	2018	2017	2018	2017
(in thousands)				
<b>Revenues:</b>				
Home sales	\$ 336,340	\$ 312,883	\$ 692,144	\$ 566,970
Land sales	2,239	912	2,314	1,484
Financial services and other revenues	1,253	—	2,750	—
	<u>\$ 339,832</u>	<u>\$ 313,795</u>	<u>\$ 697,208</u>	<u>\$ 568,454</u>
<b>Gross profit (loss):</b>				
Home sales	\$ 58,218	\$ 54,057	\$ 121,562	\$ 98,846
Land sales	276	214	(547)	212
	<u>\$ 58,494</u>	<u>\$ 54,271</u>	<u>\$ 121,015</u>	<u>\$ 99,058</u>
Selling, general and administrative	\$ 47,567	\$ 43,075	\$ 95,729	\$ 83,690
Net income <sup>(1)</sup>	\$ 8,668	\$ 7,300	\$ 20,549	\$ 1,187

(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 \$19.4 million and \$13.4 million during the six months ended November 30, 2018 and 2017, respectively.

	Three months ended November 30,		Six months ended November 30,	
	2018	2017	2018	2017
	(\$ in thousands)			
Active communities at end of period	126	142	126	142
Net new home orders (in units)	716	768	1,592	1,569
Homes closed (in units) <sup>(2)</sup>	900	754	1,785	1,386
Average sales price per home closed	\$ 374	\$ 415	\$ 388	\$ 409
Backlog at end of period (in units)	1,334	1,553	1,334	1,553
Sales value of backlog at end of period	\$ 602,981	\$ 699,553	\$ 602,981	\$ 699,553
Home gross margin <sup>(3)</sup>	17.3%	17.3%	17.6%	17.4%
Adjusted home gross margin <sup>(4)</sup>	19.3%	19.1%	19.7%	19.2%
Ratio of selling, general and administrative expenses to home sales revenue	14.1%	13.8%	13.8%	14.8%
Interest incurred <sup>(5)</sup>	\$ 11,051	\$ 10,862	\$ 21,372	\$ 20,158
Adjusted EBITDA <sup>(6)</sup>	\$ 19,693	\$ 19,308	\$ 42,883	\$ 29,327
Adjusted EBITDA margin <sup>(6)</sup>	5.8%	6.2%	6.2%	5.2%
Total debt to total capitalization	63.7%	65.3%	63.7%	65.3%
Total net debt to net capitalization	63.7%	65.3%	63.7%	65.3%
Cancellation rate (as a percentage of gross sales) <sup>(7)</sup>	28.2%	18.2%	26.2%	16.6%
Cancellation rate (as a percentage of beginning backlog) <sup>(8)</sup>	18.5%	11.1%	N/A	N/A

- (2) 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.
- (3) 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.
- (4) Adjusted home gross margin is not a financial measure under GAAP and should not be considered an alternative to home gross margin determined in accordance with GAAP as an indicator of operating performance. We use this measure to evaluate our performance against other companies in the homebuilding industry and believe it is also relevant and useful to investors. Adjusted home gross margin is home gross margin that is adjusted for inventory impairments and interest amortized to cost of sales. The following is a reconciliation of home gross margin, which is the most directly comparable GAAP measure, to adjusted home gross margin:

	Three months ended November 30,		Six months ended November 30,	
	2018	2017	2018	2017
	(in thousands)			
Home sales revenues	\$ 336,340	\$ 312,883	\$ 692,144	\$ 566,970
Cost of sales homes	278,122	258,826	570,582	468,124
Home gross margin	58,218	54,057	121,562	98,846
Add: Inventory impairments	—	47	1,898	47
Interest amortized to cost of sales	6,530	5,715	13,234	10,023
Adjusted home gross margin	\$ 64,748	\$ 59,819	\$ 136,694	\$ 108,916

- (5) Interest incurred for any period is the aggregate amount of interest that is capitalized or charged directly to general and administrative expenses during such period. The following table summarizes interest costs incurred, amortized to cost of sales, and expensed during the three and six months ended November 30, 2018 and 2017:

	Three months ended November 30,		Six months ended November 30,	
	2018	2017	2018	2017
	(in thousands)			
Capitalized interest, beginning of period	\$ 15,545	\$ 12,410	\$ 13,824	\$ 10,813
Interest incurred	11,051	10,862	21,372	20,158
Interest amortized to cost of sales	(6,530)	(5,715)	(13,234)	(10,023)
Interest expensed	(1,817)	(3,549)	(3,713)	(6,940)
Capitalized interest, end of period	<u>\$ 18,249</u>	<u>\$ 14,008</u>	<u>\$ 18,249</u>	<u>\$ 14,008</u>

- (6) Adjusted EBITDA (earnings before interest, taxes, depreciation, and amortization further adjusted to eliminate a loss from early extinguishment of debt) 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. Adjusted 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 Adjusted EBITDA in the same manner as us, the Adjusted EBITDA information in this report may not be comparable to similar presentations by others. Adjusted EBITDA margin is calculated by dividing Adjusted EBITDA by total revenues.

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

	Three months ended November 30,		Six months ended November 30,	
	2018	2017	2018	2017
	(in thousands)			
Net income	\$ 8,668	\$ 7,300	\$ 20,549	\$ 1,187
Depreciation and amortization	2,678	2,744	5,387	5,914
Interest amortized to cost of sales	6,530	5,715	13,234	10,023
Interest expensed	1,817	3,549	3,713	6,940
EBITDA	<u>19,693</u>	<u>19,308</u>	<u>42,883</u>	<u>24,064</u>
Loss from early extinguishment of debt	—	—	—	5,263
Adjusted EBITDA	<u>\$ 19,693</u>	<u>\$ 19,308</u>	<u>\$ 42,883</u>	<u>\$ 29,327</u>

- (7) The following table summarizes the cancellation rates (as a percentage of gross sales) by buyer profile for the three and six months ended November 30, 2018 and 2017:

	Three months ended November 30,		Six months ended November 30,	
	2018	2017	2018	2017
Entry-Level - Starlight Homes	42.9%	31.6%	43.3%	28.7%
Entry-Level - Ashton Woods	19.5%	10.6%	15.1%	11.6%
Move-up	17.1%	14.0%	14.5%	13.6%
Multi-Move-Up	20.4%	15.5%	22.7%	12.5%
Consolidated	28.2%	18.2%	26.2%	16.6%



- (8) The following table summarizes the cancellation rates (as a percentage of beginning backlog) by buyer profile for the three months ended November 30, 2018 and 2017:

	<b>Three months ended November 30,</b>	
	<b>2018</b>	<b>2017</b>
Entry-Level - Starlight Homes	72.5%	N/A
Entry-Level - Ashton Woods	7.5%	3.3%
Move-up	9.1%	7.3%
Multi-Move-Up	7.4%	7.0%
Consolidated	18.5%	11.1%

### Results of operations - Segments

We have grouped our homebuilding operating divisions into two reportable segments, east and central. At November 30, 2018, 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):

	<b>Three months ended November 30,</b>		<b>Six months ended November 30,</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
East	361	415	853	780
Central	355	353	739	789
Company total	716	768	1,592	1,569

#### Homes closed (units):

	<b>Three months ended November 30,</b>		<b>Six months ended November 30,</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
East	515	364	998	666
Central	385	390	787	720
Company total	900	754	1,785	1,386

#### Average sales price per home closed:

	<b>Three months ended November 30,</b>		<b>Six months ended November 30,</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
	(in thousands)			
East	\$ 370	\$ 428	\$ 384	\$ 418
Central	\$ 378	\$ 403	\$ 393	\$ 401
Company average	\$ 374	\$ 415	\$ 388	\$ 409

**Backlog (units) at end of period:**

	As of November 30,	
	2018	2017
East	769	764
Central	565	789
Company total	1,334	1,553

**Sales value of backlog at end of period:**

	As of November 30,	
	2018	2017
	(in thousands)	
East	\$ 361,158	\$ 362,672
Central	241,823	336,881
Company total	\$ 602,981	\$ 699,553

**Active communities:**

	As of November 30,	
	2018	2017
East	66	73
Central	60	69
Company total	126	142

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

	Three months ended November 30,		Six months ended November 30,	
	2018	2017	2018	2017
	(in thousands)			
<b>Homebuilding East:</b>				
Home sales revenues	\$ 190,800	\$ 155,628	\$ 383,136	\$ 278,152
Cost of sales homes	158,924	129,452	317,772	230,748
Home gross margin	31,876	26,176	65,364	47,404
Add: Inventory impairments	—	47	1,323	47
Interest amortized to cost of sales	3,851	3,078	7,870	5,319
Adjusted home gross margin	\$ 35,727	\$ 29,301	\$ 74,557	\$ 52,770
Ratio of home gross margin to home sales revenues	16.7%	16.8%	17.1%	17.0%
Ratio of adjusted home gross margin to home sales revenues	18.7%	18.8%	19.5%	19.0%

	<b>Three months ended November 30,</b>		<b>Six months ended November 30,</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
<b>Homebuilding Central:</b>	(in thousands)			
Home sales revenues	\$ 145,540	\$ 157,255	\$ 309,008	\$ 288,818
Cost of sales homes	119,198	129,374	250,912	237,376
Home gross margin	26,343	27,881	58,096	51,442
Add: Inventory impairments	—	—	574	—
Interest amortized to cost of sales	2,679	2,637	5,364	4,704
Adjusted home gross margin	\$ 29,022	\$ 30,518	\$ 64,034	\$ 56,146
Ratio of home gross margin to home sales revenues	18.1%	17.7%	18.8%	17.8%
Ratio of adjusted home gross margin to home sales revenues	19.9%	19.4%	20.7%	19.4%

## Results of operations - Discussion

### Three and Six Months Ended November 30, 2018 Compared to Three and Six Months Ended November 30, 2017

#### *Home sales revenues - Consolidated*

Home sales revenues increased by 7.5% (\$23.5 million) and 22.1% (\$125.2 million) for the three and six months ended November 30, 2018, to \$336.3 million and \$692.1 million, respectively, from \$312.9 million and \$567.0 million for the three and six months ended November 30, 2017, respectively. The increase in revenues for the three and six months ended November 30, 2018, as compared to the three and six months ended November 30, 2017, 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 19.4% (146 homes) and 28.8% (399 homes) for the three and six months ended November 30, 2018, to 900 and 1,785, respectively, compared to 754 and 1,386 for the three and six months ended November 30, 2017, respectively.

The average sales price of homes closed decreased 9.9% and 5.1% for the three and six months ended November 30, 2018 to an average of \$374,000 and \$388,000, respectively, from an average of \$415,000 and \$409,000 for the three and six months ended November 30, 2017, respectively. The decrease in the average sales price of homes closed on a consolidated basis for the three and six months ended November 30, 2018, compared to the three and six months ended November 30, 2017, was primarily due to a shift in the mix of communities from which we had closings. As discussed above, we had a higher percentage of closings in entry-level communities, with generally lower average sales prices.

#### *Home sales revenues - East segment*

Home sales revenues for the east segment increased by 22.6% (\$35.2 million) and 37.7% (\$105.0 million) for the three and six months ended November 30, 2018, to \$190.8 million and \$383.1 million, respectively, from \$155.6 million and \$278.2 million for the three and six months ended November 30, 2017, respectively. The increase in revenues for the three and six months ended November 30, 2018, as compared to the three and six months ended November 30, 2017, was due to an increase in the number of homes closed, partially offset by a decrease in the average sales price of homes closed. The number of homes closed during the three and six months ended November 30, 2018 increased 41.5% (151 homes) and 49.8% (332 homes), respectively, as compared to the three and six months ended November 30, 2017.

The average sales price of homes closed decreased 13.6% and 8.1% in the three and six months ended November 30, 2018 to an average of \$370,000 and \$384,000, respectively, from an average of \$428,000 and \$418,000 for the three and six months ended November 30, 2017, respectively. The decrease in the average sales price of homes closed for the three and six months ended November 30, 2018, compared to the three and six months ended November 30, 2017, was primarily due to a shift in the mix of communities from which we had closings. We had a higher percentage of closings in entry-level communities, with generally lower average sales prices. During the three and six months ended November 30, 2018, 264 (51%) and 513 (51%), respectively, of the homes closed were considered entry-level, compared to 123 (34%) and 227 (34%) for the three and six months ended November 30, 2017, respectively.

### *Home sales revenues - Central segment*

Home sales revenues for the central segment decreased by 7.4% (\$11.7 million) for the three months ended November 30, 2018 to \$145.5 million from \$157.3 million for the three months ended November 30, 2017. The decrease in revenues for the three months ended November 30, 2018, as compared to the three months ended November 30, 2017, was due to a decrease in the average sales price of homes closed and a slight decrease in the number of homes closed. The number of homes closed during the three months ended November 30, 2018 decreased 1.3% (5 homes) as compared to the three months ended November 30, 2017.

Home sales revenues for the central segment increased by 7.0% (\$20.2 million) for the six months ended November 30, 2018 to \$309.0 million from \$288.8 million for the six months ended November 30, 2017. The increase in revenues for the six months ended November 30, 2018, as compared to the six months ended November 30, 2017, 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 six months ended November 30, 2018 increased 9.3% (67 homes) as compared to the six months ended November 30, 2017.

The average sales price of homes closed decreased 6.2% and 2.0% in the three and six months ended November 30, 2018 to an average of \$378,000 and \$393,000, respectively, from an average of \$403,000 and \$401,000 for the three and six months ended November 30, 2017, respectively. The decrease in the average sales price of homes closed during the three and six months ended November 30, 2018, compared to the three and six months ended November 30, 2017, was primarily due to a shift in the mix of communities from which we had closings. We had a higher percentage of closings in entry-level communities, with generally lower average sales prices. During three and six months ended November 30, 2018, 140 (36%) and 264 (34%), respectively, of the homes closed were considered entry-level, compared to 62 (16%) and 118 (16%) for the three and six months ended November 30, 2017, respectively.

### *Net new home orders, cancellations, and backlog - Consolidated*

Net new home orders and backlog do not have a current effect on our revenues; however, both provide important information about our future revenues and business prospects. New home orders are converted to revenues at the time of the home closing. Net new home orders decreased 6.8% (52 homes) for the three months ended November 30, 2018 compared to the three months ended November 30, 2017. The decrease in net new home orders was largely driven by a decrease in the number of active communities while the sales pace per active community remained relatively flat for the three months ended November 30, 2018 as compared to the three months ended November 30, 2017. The mix of communities at November 30, 2018 as compared to November 30, 2017 shifted to a higher percentage of entry-level communities, which typically have a higher rate of sales.

Net new home orders increased 1.5% (23 homes) for the six months ended November 30, 2018 compared to the six months ended November 30, 2017. The increase in net new home orders was largely driven by an increase in the sales pace per active community for the six months ended November 30, 2018 as compared to the six months ended November 30, 2017 offset in part by a decrease in the number of active communities. As discussed above, the mix of communities at November 30, 2018 as compared to November 30, 2017 shifted to a higher percentage of entry-level communities, which typically have a higher rate of sales.

The cancellation rates on our entry-level homes are typically higher than the cancellation rates on our move-up and multi-move-up homes. The most common reason for these cancellations is the home buyer not being able to obtain financing. As mortgage rates have increased over the past year, we have seen a corresponding increase in cancellation rates across all of our products, but most markedly in entry-level. The cancellation rate for the three months ended November 30, 2018, both as a percentage of gross sales and as a percentage of beginning backlog, increased for the entry-level buyer profile compared to the three months ended November 30, 2017. The cancellation rate for the multi-move-up buyer profile, as a percentage of gross sales, increased due to lower gross sales during the three and six months ended November 30, 2018, compared to the three and six months ended November 30, 2017. Gross sales decreased approximately 42% and 39% for the three and six months ended November 30, 2018, respectively, compared to the three and six months ended November 30, 2017, respectively.

Backlog decreased 14.1% from 1,553 homes in backlog at November 30, 2017 to 1,334 homes in backlog at November 30, 2018. The decrease in backlog was a result of the Company selling 3,823 homes, which is 219 fewer homes than were closed (4,042 homes closed) during the twelve months ended November 30, 2018. The sales value of backlog at November 30, 2018 was \$603.0 million, a 13.8% decrease from the sales value of backlog at November 30, 2017 of \$699.6 million. The decrease in the sales value of backlog is primarily due to the 14.1% decrease in the number

of homes in backlog, as discussed above. The average sales price of homes in backlog remained flat in November 30, 2018 as compared to November 30, 2017. The average sales price of homes in backlog at November 30, 2018 was \$452,000 compared to \$450,000 at November 30, 2017.

	<b>As of November 30,</b>	
	<b>2018</b>	<b>2017</b>
<b>Backlog (units) at end of period:</b>		
Entry-Level - Starlight Homes	218	181
Entry-Level - Ashton Woods	252	191
Move-up	624	804
Multi-Move-Up	240	377
Company Total	1,334	1,553

*Net new home orders and backlog - East segment*

Net new home orders in the east segment decreased 13.0% (54 homes) during the three months ended November 30, 2018 compared to the three months ended November 30, 2017. The decrease in net new home orders was largely driven by a decrease in the number of active communities as well as a decrease in the sales per active community for the three months ended November 30, 2018 as compared to the three months ended November 30, 2017. Net new home orders in the east segment increased 9.4% (73 homes) during the six months ended November 30, 2018 compared to the six months ended November 30, 2017. The increase in net new home orders was largely driven by an increase in the sales pace per active community for the six months ended November 30, 2018 as compared to the six months ended November 30, 2017 offset in part by a decrease in the number of active communities. As discussed above, the mix of active communities at November 30, 2018 as compared to November 30, 2017 shifted to a higher percentage of entry-level communities, which typically have a higher rate of sales. Backlog consisted of 769 homes at November 30, 2018, which is a 0.7% increase from 764 homes in backlog at November 30, 2017. The increase in backlog is a result of selling 5 more homes than we closed during the twelve months ended November 30, 2018. The east segment sold 2,165 homes, while closing 2,160 homes during the twelve months ended November 30, 2018.

The sales value of backlog at November 30, 2018 was \$361.2 million, a 0.4% decrease over the sales value of backlog at November 30, 2017 of \$362.7 million, due primarily to a decrease in the average sales price of homes in backlog, partially offset by a small increase in the number of homes in backlog. The average sales price of homes in backlog at November 30, 2018 was \$470,000 compared to \$475,000 at November 30, 2017. The decrease in the average sales price of homes in backlog is a result of the mix of types of communities with homes in backlog. As discussed above, the shift in the mix of active communities has trended more towards those we consider to be entry-level, which have a lower average sales price. Of the 769 homes in backlog at November 30, 2018, 290 (38%) of the homes were considered entry-level, compared to 201 (26%) of the 764 homes in backlog at November 30, 2017.

	<b>As of November 30,</b>	
	<b>2018</b>	<b>2017</b>
<b>Backlog (units) at end of period:</b>		
Entry-Level - Starlight Homes	150	102
Entry-Level - Ashton Woods	140	99
Move-up	301	311
Multi-Move-Up	178	252
Segment Total	769	764

*Net new home orders and backlog - Central segment*

Net new home orders in the central segment increased 0.6% (2 homes) during the three months ended November 30, 2018 compared to the three months ended November 30, 2017. The increase in net new home orders was largely driven by an increase in the sales pace per active community for the three months ended November 30, 2018 as compared to

the three months ended November 30, 2017 offset in part by a decrease in the number of active communities. Net new home orders in the central segment decreased 6.3% (50 homes) during the six months ended November 30, 2018 compared to the six months ended November 30, 2017. The decrease in net new home orders was largely driven by a decrease in the number of active communities as well as a decrease in the sales pace per active community for the six months ended November 30, 2018 as compared to the six months ended November 30, 2017. Backlog consisted of 565 homes at November 30, 2018, which is a 28.4% decrease from 789 homes in backlog at November 30, 2017. The decrease in backlog is the result of selling 224 fewer homes than were closed during the twelve months ended November 30, 2018. The central segment sold 1,658 homes, while closing 1,882 homes during the twelve months ended November 30, 2018.

The sales value of backlog at November 30, 2018 was \$241.8 million, a 28.2% decrease over sales value of backlog at November 30, 2017 of \$336.9 million due to the 28.4% decrease in the number of homes in backlog as discussed above.

	<b>As of November 30,</b>	
	<b>2018</b>	<b>2017</b>
<b>Backlog (units) at end of period:</b>		
Entry-Level - Starlight Homes	68	79
Entry-Level - Ashton Woods	112	92
Move-up	323	493
Multi-Move-Up	62	125
Segment Total	<u>565</u>	<u>789</u>

#### *Gross margins - Consolidated*

The average gross margin from homes closed for the three months ended November 30, 2018 remained unchanged at 17.3% compared to the three months ended November 30, 2017. The average gross margin from homes closed for the six months ended November 30, 2018 increased to 17.6% from 17.4% for the six months ended November 30, 2017. The increase in average gross margin for the six months ended November 30, 2018 was due to a reduction in construction costs as a percentage of revenue due to shifts in community mix, primarily offset by impairment charges and an increase in land costs as a percentage of revenue. The Company added 38 new active communities while closing out 54 communities, during the twelve months ended November 30, 2018. These new communities typically have higher land costs as a percentage of revenue due to the rising land prices over the past several years. The Company recorded impairment charges of \$1.9 million and \$47,000 during the six months ended November 30, 2018 and 2017, respectively. The Company recorded impairment charges of \$1.3 million and \$0.6 million in the east segment and central segment, respectively, during the six months ended November 30, 2018. See Note 1(d) for additional information on the impairment charges recorded during the six months ended November 30, 2018.

Adjusted gross margin from homes closed for the three months ended November 30, 2018 increased to 19.3% from 19.1% for the three months ended November 30, 2017. This increase in the adjusted gross margin was due to the decrease in impairment charges offset in part by a slight increase in interest amortized through cost of sales. Adjusted gross margin from homes closed for the six months ended November 30, 2018 increased to 19.7% from 19.2% for the six months ended November 30, 2017. This increase in the adjusted gross margin was due to the increase in impairment charges, as discussed above, in addition to a slight increase in interest amortized through cost of sales.

#### *Gross margins - East segment*

The average gross margin from homes closed in the east segment for the three months ended November 30, 2018 decreased to 16.7% from 16.8% for the three months ended November 30, 2017, while the average gross margin from homes closed in the east segment for the six months ended November 30, 2018 remained relatively flat at 17.1%, as compared to 17.0% for the six months ended November 30, 2017. The decrease in average gross margin for the three months ended November 30, 2018 as compared to the three months ended November 30, 2017 was primarily due to a reduction in indirect and closing costs as a percentage of revenue due to shifts in community mix, offset in part by reductions in construction costs as a percentage of revenue due to shifts in community mix. The Company recorded impairment charges of \$1.3 million in the east segment during the six months ended November 30, 2018.

### *Gross margins - Central segment*

The average gross margin from homes closed in the central segment for the three and six months ended November 30, 2018 increased to 18.1% and 18.8%, respectively, from 17.7% and 17.8% for the three and six months ended November 30, 2017, respectively. The increase in average gross margin for the three and six months ended November 30, 2018 as compared to the three and six months ended November 30, 2017 was due to reductions in construction costs as a percentage of revenue due to shifts in community mix and was offset in part by an increase in land costs as a percentage of revenue and impairment charges. The Company continues to close out of older communities and open new communities, for which land costs as a percentage of revenue tends to be higher due to the rising land prices over the past several years. The Company recorded an impairment charge of \$0.6 million in the central segment during the six months ended November 30, 2018.

### *Selling, general and administrative expenses*

SG&A totaled \$47.6 million and \$95.7 million for the three and six months ended November 30, 2018, respectively, compared to \$43.1 million and \$83.7 million for the three and six months ended November 30, 2017, respectively.

SG&A as a percentage of revenue increased to 14.1% for the three months ended November 30, 2018 from 13.8% for the three months ended November 30, 2017. The increase in SG&A as a percentage of revenue for the three months ended November 30, 2018 as compared to the three months ended November 30, 2017 was primarily related to an increase in commissions as a percentage of revenue due to an increase in the number of homes closed in entry-level communities, which typically have higher commissions as a percentage of revenue.

SG&A as a percentage of revenue decreased to 13.8% for the six months ended November 30, 2018 from 14.8% for the six months ended November 30, 2017. The decrease in SG&A as a percentage of revenue for the six months ended November 30, 2018 was primarily related to a decrease in sales and marketing expenses as a percentage of revenue due to a larger percentage of our communities with selling activity in entry-level communities, which typically have lower sales office and model expenses as a percentage of revenue, and a decrease in compensation and benefit expenses as a percentage of revenue. While total compensation and benefit expenses increased for the six months ended November 30, 2018 as compared to the six months ended November 30, 2017, compensation and benefit expenses as a percentage of revenue decreased for the six months ended November 30, 2018 as compared to the six months ended November 30, 2017 as a result of the 19.4% increase in closings.

### *Land sales*

We periodically elect to sell parcels of land or lots. These land and lot sales are incidental to our business of selling and building homes. We had \$2.2 million and \$2.3 million in sales of land and lots during the three and six months ended November 30, 2018, respectively, and \$0.9 million and \$1.5 million in sales of land and lots during the three and six months ended November 30, 2017, respectively. As discussed in Note 1(d), the Company recorded impairment charges on land that was held for sale of \$0.8 million during the six months ended November 30, 2018.

### *Net income*

Net Income increased \$1.4 million and \$19.4 million, respectively, for the three and six months ended November 30, 2018 as compared to the three and six months ended November 30, 2017.

The increase in net income for the three months ended November 30, 2018 as compared to the three months ended November 30, 2017 is primarily attributable to an increase in revenues for the three months ended November 30, 2018 as compared to the three months ended November 30, 2017 and was partially offset by an increase in SG&A expense as a percentage of revenue.

The increase in net income for the six months ended November 30, 2018 as compared to the six months ended November 30, 2017 is primarily attributable to an increase in revenues for the six months ended November 30, 2018 as compared to the six months ended November 30, 2017, a decrease in SG&A expense as a percentage of revenue, and the \$5.3 million loss from the early extinguishment of debt related to the debt transactions discussed in Note 6 incurred during six months ended November 30, 2017, which did not recur during the six months ended November 30, 2018.

## Liquidity and capital resources

We currently fund our operations with proceeds from the sales of homes and land, borrowings under our First Amendment to Fifth Amended and Restated Credit Agreement dated as of June 23, 2017 (as amended to date, the "Restated Revolver"), long-term financing, and investments of equity. Our principal uses of cash are land and lot purchases, land development, home construction, repayments under our Restated Revolver, interest costs, and overhead. As we utilize our capital resources and liquidity to fund the growth of our business, we monitor our balance sheet leverage ratios to ensure that we maintain reasonable levels. We also monitor current and expected operational requirements, as well as financial market conditions, to evaluate accessing other available financing sources. Based on our existing financial condition and credit relationships, we believe that our operations and capital resources are sufficient to provide for our current and foreseeable capital needs. However, we continue to evaluate the impact of market conditions on our liquidity and will consider, as appropriate, additional funding opportunities.

### *Operating cash flows*

Net cash used in operating activities for the six months ended November 30, 2018 was \$116.6 million compared to \$99.4 million of net cash used in operating activities for the six months ended November 30, 2017. The primary sources of funds from operations are from the closing of homes and changes in the level of inventory, each of which experiences seasonal fluctuations. The increase in net cash used in operations for the six months ended November 30, 2018 was primarily due to an increase in inventory of \$134.9 million as the result of land acquisition and development investments to support future operations, as well as more homes under construction, offset by our net income of \$20.5 million and deposits on real estate under option or contract.

### *Investing cash flows*

Net cash used in investing activities was \$4.2 million for the six months ended November 30, 2018 and \$0.9 million for the six months ended November 30, 2017. Net cash used in investing activities for the six months ended November 30, 2018 included \$4.2 million to furnish and/or update furnishings in model homes and sales offices.

### *Financing cash flows*

Net cash provided by financing activities was \$93.1 million for the six months ended November 30, 2018, compared to \$100.4 million for the six months ended November 30, 2017. The funds provided by financing activities during the six months ended November 30, 2018 consisted of \$112.5 million of net borrowings on the Restated Revolver, offset by distributions of \$19.4 million to our Members. As of November 30, 2018, we had outstanding borrowings of \$112.5 million under our Restated Revolver and available additional borrowing capacity of \$127.7 million based on outstanding letters of credit and the value of collateral pledged to secure the facility.

The total debt to total capitalization ratio consists of total debt divided by total capitalization (debt plus members' equity). Our ratio of total debt to total capitalization decreased to 63.7% at November 30, 2018 from 65.3% at November 30, 2017. 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 63.7% at November 30, 2018 from 65.3% at November 30, 2017.

## Inventory

As of November 30, 2018, we had the following owned homes in our reportable segments (in units):

	Homes Under Construction			Completed Homes			Total Homes
	Unsold	Models	Sold	Unsold	Models	Sold	
East	748	16	574	140	57	89	1,624
Central	493	10	390	112	64	91	1,160
Company total	1,241	26	964	252	121	180	2,784



As of November 30, 2018 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	1,624	1,205	490	128	3,447	11,561	15,008
Central	1,160	784	1,413	744	4,101	10,207	14,308
<b>Total Company</b>	<b>2,784</b>	<b>1,989</b>	<b>1,903</b>	<b>872</b>	<b>7,548</b>	<b>21,768</b>	<b>29,316</b>
Percentage of total controlled	9.5%	6.8%	6.5%	3.0%	25.7%	74.3%	100.0%

As of November 30, 2018 and 2017, we had the following unsold homes in inventory (in units):

	November 30, 2018	November 30, 2017
Entry-Level - Starlight Homes	498	182
Entry-Level - Ashton Woods	191	133
Move-up	565	431
Multi-Move-Up	239	160
<b>Consolidated</b>	<b>1,493</b>	<b>906</b>

The total number of unsold homes in inventory increased 587 units from 906 in November 30, 2017 to 1,493 in November 30, 2018. The increase is comprised of an increase of 57 unsold completed homes and an increase of 530 unsold homes under construction. The increase of 57 unsold completed homes is primarily driven by an increase in the entry-level communities in both our Ashton Woods and Starlight Homes brands. These entry-level communities are typically focused on selling homes that are either already under construction or completed. The increase of 530 unsold homes under construction is primarily made up of an increase in our entry-level active communities, as discussed above, as well as homes under construction in entry-level communities that have not yet opened for sales.

In addition to the 7,548 lots we owned, we controlled, through the use of purchase and option agreements, 21,768 lots at November 30, 2018. Purchase and option agreements that did not require consolidation under Accounting Standard Codification (“ASC”) Subtopic 810, *Consolidations*, ASC Subtopic 360-20, *Property, Plant, and Equipment* (“ASC 360-20”), or ASC Subtopic 470-40, *Product Financing Arrangements* (“ASC 470-40”) at November 30, 2018 had an aggregate remaining purchase price of \$974.1 million. In connection with these agreements, we had cash deposits of \$109.0 million at November 30, 2018. In addition, we had purchase and option agreements consolidated under ASC 360-20 or ASC 470-40 with an aggregate remaining purchase price of \$81.8 million and cash deposits of \$24.5 million (See Note 4 to our unaudited condensed consolidated financial statements as of November 30, 2018).

During the six months ended November 30, 2018, we acquired 2,356 lots for a total purchase price of \$158.1 million. We subsequently sold 264 lots (\$18.1 million) that were accounted for under the provisions of ASC 360-20 due to the Company's continuing involvement. We spent \$49.9 million on land development during the six months ended November 30, 2018. We spent \$4.2 million during the six months ended November 30, 2018 to furnish and/or update furnishings in model homes and sales offices.

### **Aggregate contractual commitments and off-balance sheet arrangements**

There have been no significant changes outside the ordinary course of business to our contractual obligations under our debt agreements and lease payments as of November 30, 2018, compared to those contained in our audited consolidated financial statements for the year ended May 31, 2018. Our debt obligations are fully discussed in Note 6 of our unaudited condensed consolidated financial statements as of November 30, 2018.

In the ordinary course of business, we provide letters of credit and surety bonds to third parties to secure performance and provide deposits under various contracts and commitments. At November 30, 2018, we had letters of credit and surety bonds outstanding of \$7.1 million and \$43.7 million, respectively. As of November 30, 2018, we had \$37.9 million of unused letter of credit capacity under the Restated Revolver.

At November 30, 2018, we controlled 29,316 lots and homes available to close. Of the 29,316 lots and homes controlled, we owned 25.7%, or 7,548 lots and homes, and 74.3%, or 21,768 lots, were under contract. In the ordinary course of business, we enter into purchase and option agreements in order to procure land for the construction of homes in the future. At November 30, 2018, these agreements had an aggregate remaining purchase price of \$974.1 million, net of deposits of \$109.0 million. In addition, we had purchase and option agreements recorded under ASC 360-20 or ASC 470-40 with an aggregate remaining purchase price of \$81.8 million and cash deposits of \$24.5 million. Pursuant to these land purchase and land option agreements, we generally provide a deposit to the seller as consideration for the right, but not the obligation, to purchase land at different times in the future, usually at predetermined prices. In certain instances, we are required to record the land under option as if we own it.

As of November 30, 2018, real estate not owned totaled \$70.9 million related to ten lot purchase agreements with \$24.5 million of non-refundable deposits. Refer to our discussion in Note 4 of our unaudited condensed consolidated financial statements as of November 30, 2018.

As of November 30, 2018, we participated in two land development joint ventures in which we have less than a controlling interest. We account for our interests in these joint ventures under the equity method. Our share of profits from lots we purchase from these entities is deferred until we close on the home. Our share of profits from lots purchased by other parties is recognized at the time of sale and included within equity in earnings in unconsolidated entities in the unaudited condensed consolidated statements of income.

As of November 30, 2018, we participated in a mortgage joint venture in which we offer residential mortgage services to our homebuyers and the public at large in Austin, Dallas, Houston, San Antonio, and Phoenix. The Company does not have a controlling interest in the joint venture. We account for our interest in the mortgage joint venture under the equity method. Our share of profits is included within equity in earnings in unconsolidated entities in the unaudited condensed consolidated statements of income.

### **Seasonality and inflation**

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

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

### **Critical accounting policies and estimates**

There have been no significant changes to our critical accounting policies and estimates during the six months ended November 30, 2018, compared with those disclosed in our audited consolidated financial statements for the fiscal year ended May 31, 2018, except that we updated our revenue recognition policies pursuant to the adoption of ASC 606 as discussed in Note 1(j) and Note 2 to our unaudited condensed consolidated financial statements as of November 30, 2018.

### **Transactions with related parties**

See Note 9 to our unaudited condensed consolidated financial statements as of November 30, 2018 for the transactions with related parties. The Company did not have any significant changes in or transactions with related parties during the first six months of fiscal year 2019. See the audited consolidated financial statements for the fiscal year ended May 31, 2018 for transactions existing at such date.

## **Pending accounting pronouncements**

See Note 2 to our unaudited condensed consolidated financial statements as of November 30, 2018.

## **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 rates and LIBOR. For our variable-rate debt, our primary exposure is in interest expense.

The borrowings under the Restated Revolver accrue interest at a variable rate. As of November 30, 2018, we had outstanding borrowings of \$112.5 million under the Restated Revolver.

## **Item 4. *Controls and Procedures***

Pursuant to section 4.03 of each of the indentures governing the 6.875% Notes and 6.750% Notes, the Company is not required to comply with Section 302 or Section 404 of the Sarbanes-Oxley Act of 2002, or related Items 307 and 308 of Regulation S-K promulgated by the Securities and Exchange Commission.

## **PART II. OTHER INFORMATION**

### **Item 1. *Legal Proceedings***

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

In addition, on June 27, 2016, FCC Marsh, LLC (the “Seller”) filed a complaint against the Company in the Circuit Court for Collier County, Florida, alleging that the Company breached a lot purchase agreement that provided the Seller with a specific performance right against the Company, subject to certain conditions, by allegedly failing to close on certain lot purchases. The Seller dismissed its claim for specific performance, and seeks declaratory relief and damages. The Company filed a counterclaim seeking declaratory relief, return of the earnest money deposit, foreclosure of the mortgage that secures that deposit, and damages for the Seller's breach of a lease agreement between the parties. While it is premature to predict the ultimate outcome of these proceedings, the Company intends to vigorously defend the lawsuit and pursue its claims against the Seller.