

AMERICAN REALTY INVESTORS INC
Form 10-Q
May 15, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2014

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 001-15663

AMERICAN REALTY INVESTORS, INC.

(Exact Name of Registrant as Specified in Its Charter)

Nevada
(State or Other Jurisdiction of
Incorporation or Organization)

75-2847135
(I.R.S. Employer
Identification No.)

1603 Lyndon B. Johnson Freeway, Suite 800, Dallas, Texas 75234
(Address of principal executive offices)
(Zip Code)

(469) 522-4200
(Registrant's telephone number, including area code)

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

Edgar Filing: AMERICAN REALTY INVESTORS INC - Form 10-Q

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

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

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

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

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date.

Common Stock, \$.01 par value (Class)	11,525,389 (Outstanding at May 5, 2014)
--	--

AMERICAN REALTY INVESTORS, INC.
FORM 10-Q
TABLE OF CONTENTS

	PAGE	
PART I. FINANCIAL INFORMATION		
Item 1.	Financial Statements	
	Consolidated Balance Sheets at March 31, 2014 (unaudited) and December 31, 2013	3
	Consolidated Statements of Operations for the three months ended March 31, 2014 and 2013 (unaudited)	4
	Consolidated Statement of Shareholders' Equity for the three months ended March 31, 2014 (unaudited)	5
	Consolidated Statements of Comprehensive Income (Loss) for the three months ended March 31, 2014 and 2013 (unaudited)	6
	Consolidated Statements of Cash Flows for the three months ended March 31, 2014 and 2013 (unaudited)	7
	Notes to Consolidated Financial Statements	8
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	22
Item 3.	Quantitative and Qualitative Disclosures About Market Risks	30
Item 4.	Controls and Procedures	30
PART II. OTHER INFORMATION		
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	31
Item 6.	Exhibits	32
SIGNATURES		33

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

AMERICAN REALTY INVESTORS, INC.
CONSOLIDATED BALANCE SHEETS
(unaudited)

	March 31, 2014	December 31, 2013
	(dollars in thousands, except share and par value amounts)	
Assets		
Real estate, at cost	\$770,960	\$799,698
Real estate held for sale at cost, net of depreciation (\$27,282 for 2014 and \$2,390 for 2013)	9,787	16,427
Real estate subject to sales contracts at cost, net of depreciation (\$2,036 for 2014 and \$1,949 for 2013)	23,335	27,598
Less accumulated depreciation	(120,468)	(143,429)
Total real estate	683,614	700,294
Notes and interest receivable		
Performing (including \$138,086 in 2014 and \$145,754 in 2013 from related parties)	145,670	153,275
Non-performing	3,129	3,140
Less allowance for doubtful accounts (including \$15,809 in 2014 and 2013 from related parties)	(19,579)	(19,600)
Total notes and interest receivable	129,220	136,815
Cash and cash equivalents	18,384	16,437
Restricted cash	27,736	32,929
Investments in unconsolidated subsidiaries and investees	3,990	3,789
Receivable from related party	34,751	14,086
Other assets	42,461	38,972
Total assets	\$940,156	\$943,322
Liabilities and Shareholders' Equity		
Liabilities:		
Notes and interest payable	\$629,364	\$618,930
Notes related to assets held for sale	15,717	17,100
Notes related to subject to sales contracts	20,991	23,012
Deferred revenue (including \$74,303 in 2014 and 2013 from sales to related parties)	76,148	76,148
Accounts payable and other liabilities (including \$15,954 in 2014 and \$15,394 in 2013 to related parties)	59,400	73,271
	801,620	808,461
Shareholders' equity:		
	4,908	4,908

Edgar Filing: AMERICAN REALTY INVESTORS INC - Form 10-Q

Preferred stock, Series A: \$2.00 par value, authorized 15,000,000 shares, issued and outstanding 3,353,954 shares in 2014 and 2013 (liquidation preference \$10 per share), including 900,000 shares in 2014 and 2013 held by subsidiaries. Series K: \$2.00 par value, authorized, issued and outstanding 135,000 shares in 2014 and 2013, respectively (liquidation preference \$22 per share)		
Common stock, \$0.01 par value, authorized 100,000,000 shares; issued 11,941,174 shares and outstanding 11,525,389 shares in 2014 and 2013	115	115
Treasury stock at cost; 415,785 shares in 2014 and 2013 and 229,214 shares held by TCI (consolidated) as of 2014 and 2013	(6,395)	(6,395)
Paid-in capital	102,280	102,974
Retained earnings	(8,245)	(11,795)
Total American Realty Investors, Inc. shareholders' equity	92,663	89,807
Non-controlling interest	45,873	45,054
Total equity	138,536	134,861
Total liabilities and equity	\$940,156	\$943,322

The accompanying notes are an integral part of these consolidated financial statements.

AMERICAN REALTY INVESTORS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

	For the Three Months Ended March 31,	
	2014	2013
	(dollars in thousands, except per share amounts)	
Revenues:		
Rental and other property revenues (including \$175 and \$165 for the three months ended 2014 and 2013, respectively, from related parties)	\$20,583	\$20,350
Expenses:		
Property operating expenses (including \$156 and \$204 for the three months ended 2014 and 2013, respectively, from related parties)	10,317	9,982
Depreciation and amortization	4,476	3,755
General and administrative (including \$918 and \$890 for the three months ended 2014 and 2013, respectively, from related parties)	1,994	2,012
Provision on impairment of notes receivable and real estate assets	-	-
Net income fee to related party	490	56
Advisory fee to related party	2,242	2,554
Total operating expenses	19,519	18,359
Operating income	1,064	1,991
Other income (expenses):		
Interest income (including \$3,797 and \$3,410 for the three months 2014 and 2013, respectively, from related parties)	4,117	3,541
Other income	178	2,536
Mortgage and loan interest (including \$798 and \$910 for the three months ended 2014 and 2013, respectively, from related parties)	(8,474)	(9,444)
Deferred borrowing costs amortization	(939)	(2,461)
Loan charges and prepayment penalties	(1,582)	(3,937)
Gain (loss) on sale of investments	-	(8)
Earnings from unconsolidated subsidiaries and investees	70	213
Litigation settlement	3,839	(45)
Total other expenses	(2,791)	(9,605)
Loss before gain on land sales, non-controlling interest, and taxes	(1,727)	(7,614)
Gain (loss) on land sales	753	(35)
Net loss from continuing operations before taxes	(974)	(7,649)
Income tax benefit	1,870	2,673
Net income (loss) from continuing operations	896	(4,976)
Discontinued operations:		

Edgar Filing: AMERICAN REALTY INVESTORS INC - Form 10-Q

Net income (loss) from discontinued operations	(710)	411
Gain on sale of real estate from discontinued operations	6,053		7,227
Income tax expense from discontinued operations	(1,870)	(2,673)
Net income from discontinued operations	3,473		4,965
Net income (loss)	4,369		(11)
Net (income) loss attributable to non-controlling interest	(819)	385
Net income attributable to American Realty Investors, Inc.	3,550		374
Preferred dividend requirement	(613)	(613)
Net income (loss) applicable to common shares	\$2,937		\$(239)
Earnings per share - basic			
Net loss from continuing operations	\$(0.05)	\$(0.45)
Net income from discontinued operations	0.30		0.43
Net income (loss) applicable to common shares	\$0.25		\$(0.02)
Earnings per share - diluted			
Net loss from continuing operations	\$(0.05)	\$(0.45)
Net income from discontinued operations	0.30		0.43
Net income (loss) applicable to common shares	\$0.25		\$(0.02)
Weighted average common shares used in computing earnings per share	11,525,389		11,525,389
Weighted average common shares used in computing diluted earnings per share	11,525,389		11,525,389
Amounts attributable to American Realty Investors, Inc.			
Net income (loss) from continuing operations	\$77		\$(4,591)
Net income from discontinued operations	3,473		4,965
Net income applicable to American Realty Investors, Inc.	\$3,550		\$374

The accompanying notes are an integral part of these consolidated financial statements.

AMERICAN REALTY INVESTORS, INC.
 CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
 For the Three Months Ended March 31, 2014
 (unaudited, dollars in thousands, except share amounts)

	Total Equity	Comprehensive Income (Loss)	Preferred Stock	Common Shares	Stock Amount	Treasury Stock	Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Non-controlling Interest
Balance, December 31, 2013	\$134,861	\$(93,213)	\$4,908	11,941,174	\$115	\$(6,395)	\$102,974	\$(11,795)	\$-	\$45,054
Net income	4,369	4,369	-	-	-	-	-	3,550	-	819
Sale of non-controlling interests	(81)	-	-	-	-	-	(81)	-	-	-
Series A preferred stock dividend (\$1.00 per share)	(613)	-	-	-	-	-	(613)	-	-	-
Balance, March 31, 2014	\$138,536	\$(88,844)	\$4,908	11,941,174	\$115	\$(6,395)	\$102,280	\$(8,245)	\$-	\$45,873

The accompanying notes are an integral part of these consolidated financial statements.

AMERICAN REALTY INVESTORS, INC.
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
 (unaudited)

	For the Three Months Ended March 31,	
	2014	2013
	(dollars in thousands)	
Net income (loss)	\$4,369	\$(11)
Other comprehensive income (loss)	-	-
Total comprehensive income (loss)	4,369	(11)
Comprehensive (income) loss attributable to non-controlling interest	(819)	385
Comprehensive income attributable to American Realty Investors, Inc.	\$3,550	\$374

The accompanying notes are an integral part of these consolidated financial statements.

AMERICAN REALTY INVESTORS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	For the Three Months Ended March 31,	
	2014	2013
	(dollars in thousands)	
Cash Flow From Operating Activities:		
Net income (loss)	\$4,369	\$(11)
Adjustments to reconcile net income (loss) applicable to common shares to net cash flow from operating activities:		
(Gain) loss on sale of land	(753)	35
Gain on sale of income-producing properties	(6,053)	(7,227)
Depreciation and amortization	4,642	5,189
Amortization of deferred borrowing costs	1,220	2,479
Earnings from unconsolidated subsidiaries and investees	(70)	(213)
Decrease (increase) in assets:		
Accrued interest receivable	12,044	1,917
Other assets	(38)	(857)
Prepaid expense	(768)	(580)
Escrow	4,585	11,487
Earnest money	535	375
Rent receivables	(220)	726
Decrease in liabilities:		
Accrued interest payable	(214)	115
Payable to related parties	(20,665)	(9,028)
Other liabilities	(13,801)	(14,334)
Net cash used in operating activities	(15,187)	(9,927)
Cash Flow From Investing Activities:		
Origination or advances of notes receivable	(4,428)	(145)
Acquisition of land held for development	(3,425)	-
Proceeds from sale of income-producing properties	22,480	24,267
Proceeds from sale of land	1,504	2,550
Investment in unconsolidated real estate entities	(131)	(1,708)
Improvement of land held for development	(115)	(71)
Improvement of income-producing properties	(1,162)	(964)
Acquisition of non-controlling interest	-	(81)
Construction and development of new properties	(205)	(115)
Net cash provided by investing activities	14,518	23,733
Cash Flow From Financing Activities:		
Proceeds from notes payable	65,212	78,345
Recurring amortization of principal on notes payable	(4,874)	(4,557)
Payments on maturing notes payable	(52,907)	(94,725)
Stock-secured borrowings	(187)	(411)
Deferred financing costs	(3,934)	(1,581)
Distributions to non-controlling interests	(81)	-

Edgar Filing: AMERICAN REALTY INVESTORS INC - Form 10-Q

Preferred stock dividends - Series A	(613)	(613)
Net cash provided by (used in) financing activities	2,616		(23,542)
Net increase (decrease) in cash and cash equivalents	1,947		(9,736)
Cash and cash equivalents, beginning of period	16,437		13,399	
Cash and cash equivalents, end of period	\$18,384		\$3,663	
Supplemental disclosures of cash flow information:				
Cash paid for interest	\$8,784		\$11,173	

The accompanying notes are an integral part of these consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. ORGANIZATION AND BASIS OF PRESENTATION

Organization

As used herein, the terms “ARL”, “the Company”, “we”, “our” or “us” refer to American Realty Investors, Inc., a Nevada corporation, which was formed in November 1999. In August 2000, the Company acquired American Realty Trust, Inc. (“ART”), a Georgia corporation and National Realty, L.P. (“NRLP”), a Delaware partnership.

The Company is headquartered in Dallas, Texas and its common stock trades on the New York Stock Exchange (“NYSE”) under the symbol (“ARL”). Approximately 87.4% of ARL’s stock is owned by related parties. Subsidiaries of ARL own approximately 83.8% of the outstanding shares of common stock of Transcontinental Realty Investors, Inc. (“TCI”), a Nevada corporation, which has its common stock listed and traded on the New York Stock Exchange (“NYSE”) under the symbol (“TCI”). ARL is a “C” corporation for U.S. federal income tax purposes and has consolidated TCI’s accounts and operations since March 2003. During the third quarter 2012, Realty Advisors Management, Inc. and its subsidiaries acquired more than 80% of ARL stock and as a result, ARL joined the Realty Advisors Management, Inc. consolidated group for federal income tax reporting. We have no employees.

TCI, a subsidiary of ARL, owns approximately 81.1% of the common stock of Income Opportunity Realty Investors, Inc. (“IOT”). Effective July 17, 2009, IOT’s financial results were consolidated with those of ARL and TCI and their subsidiaries. Shares of IOT are traded on the NYSE MKT under the symbol (“IOT”).

ARL invests in real estate through direct ownership, leases and partnerships and also invests in mortgage loans on real estate. Pillar Income Asset Management, Inc. (“Pillar”) is the Company’s external Advisor and Cash Manager. Although the Board of Directors is directly responsible for managing the affairs of ARL, and for setting the policies which guide it, the day-to-day operations of ARL are performed by Pillar, as the contractual Advisor, under the supervision of the Board. Pillar’s duties include, but are not limited to, locating, evaluating and recommending real estate and real estate-related investment opportunities and arranging debt and equity financing for the Company with third party lenders and investors. Additionally, Pillar serves as a consultant to the Board with regard to their decisions in connection with ARL’s business plan and investment policy. Pillar also serves as an Advisor and Cash Manager to TCI and IOT.

Regis Realty Prime, LLC (“Regis”) manages our commercial properties and provides brokerage services. ARL engages third-party companies to lease and manage its apartment properties. TCI also has a development agreement with Unified Housing Foundation, Inc. (“UHF”) a non-profit corporation that provides management services for the development of residential apartment projects in the future. This development agreement was terminated December 31, 2013.

Properties

We own or had interests in a total property portfolio of 46 income-producing properties as of March 31, 2014. The properties consisted of:

• 10 commercial properties consisting of six office buildings, one industrial warehouse, and three retail centers comprising in aggregate approximately 2.6 million rentable square feet;

- 36 apartment communities totaling 6,166 units, excluding apartments being developed; and

- 4,209 acres of developed and undeveloped land.

We join with various third-party development companies to construct residential apartment communities. We are in the predevelopment process on several residential apartment communities but have not yet begun construction. At March 31, 2014, we had no apartment projects in development. The third-party developer typically holds a general partner as well as a majority limited partner interest in a limited partnership formed for the purpose of building a single property while we generally take a minority limited partner interest in the limited partnership. We may contribute land to the partnership as part of our equity contribution or we may contribute the necessary funds to the partnership to acquire the land. We are required to fund all required equity contributions while the third-party developer is responsible for obtaining construction financing, hiring a general contractor and for the overall management, successful completion and delivery of the project. We generally bear all the economic risks and rewards of ownership in these partnerships and therefore include these partnerships in our consolidated financial statements. The third-party developer is paid a developer fee typically equal to a percentage of the construction costs. When the project reaches stabilized occupancy, we acquire the third-party developer's partnership interests in exchange for any remaining unpaid developer fees.

Basis of Presentation

The accompanying unaudited Consolidated Financial Statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP, have been condensed or omitted in accordance with such rules and regulations, although management believes the disclosures are adequate to prevent the information presented from being misleading. In the opinion of management, all adjustments (consisting of normal recurring matters) considered necessary for a fair presentation have been included. The results of operations for the three months ended March 31, 2014 are not necessarily indicative of the results that may be expected for other interim periods or for the full fiscal year.

The year-end Consolidated Balance Sheet at December 31, 2013 was derived from the audited financial statements at that date, but does not include all of the information and disclosures required by GAAP for complete financial statements. For further information, refer to the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013. Certain 2013 financial statement amounts have been reclassified to conform to the 2014 presentation, including adjustments for discontinued operations.

Principles of Consolidation

The accompanying Consolidated Financial Statements include the accounts of the Company, its subsidiaries, generally all of which are wholly-owned, and all entities in which we have a controlling interest. Arrangements that are not controlled through voting or similar rights are accounted for as a Variable Interest Entity ("VIE"), in accordance with the provisions and guidance of ASC Topic 810, "Consolidation", whereby we have determined that we are a primary beneficiary of the VIE and meet certain criteria of a sole general partner or managing member as identified in accordance with Emerging Issues Task Force ("EITF") Issue 04-5, Investor's Accounting for an Investment in a Limited Partnership when the Investor is the Sole General Partner and the Limited Partners have Certain Rights ("EITF 04-5"). VIEs are generally entities that lack sufficient equity to finance their activities without additional financial support from other parties or whose equity holders as a group lack adequate decision making ability, the obligation to absorb expected losses or residual returns of the entity, or have voting rights that are not proportional to their economic interests. The primary beneficiary generally is the entity that provides financial support and bears a majority of the financial risks, authorizes certain capital transactions, or makes operating decisions that materially affect the entity's financial results. All significant intercompany balances and transactions have been eliminated in consolidation.

In determining whether we are the primary beneficiary of a VIE, we consider qualitative and quantitative factors, including, but not limited to: the amount and characteristics of our investment; the obligation or likelihood for us or other investors to provide financial support; our and the other investors' ability to control or significantly influence key decisions for the VIE; and the similarity with and significance to the business activities of us and the other investors. Significant judgments related to these determinations include estimates about the current future fair values and performance of real estate held by these VIEs and general market conditions.

For entities in which we have less than a controlling financial interest or entities where we are not deemed to be the primary beneficiary, the entities are accounted for using the equity method of accounting. Accordingly, our share of the net earnings or losses of these entities is included in consolidated net income. Our investment in Grappa Florentina, LLC is accounted for under the equity method.

Real Estate, Depreciation and Impairment

Real estate assets are stated at the lower of depreciated cost or fair value, if deemed impaired. Major replacements and betterments are capitalized and depreciated over their estimated useful lives. Depreciation is computed on a straight-line basis over the useful lives of the properties (buildings and improvements – 10-40 years; furniture, fixtures and equipment – 5-10 years). The Company continually evaluates the recoverability of the carrying value of its real estate assets using the methodology prescribed in ASC Topic 360, “Property, Plant and Equipment”. Factors considered by management in evaluating impairment of its existing real estate assets held for investment include significant declines in property operating profits, annually recurring property operating losses and other significant adverse changes in general market conditions that are considered permanent in nature. Under ASC Topic 360, a real estate asset held for investment is not considered impaired if the undiscounted, estimated future cash flows of an asset (both the annual estimated cash flow from future operations and the estimated cash flow from the theoretical sale of the asset) over its estimated holding period are in excess of the asset’s net book value at the balance sheet date. If any real estate asset held for investment is considered impaired, a loss is provided to reduce the carrying value of the asset to its estimated fair value.

Real Estate Held For Sale

We periodically classify real estate assets as “held for sale”. An asset is classified as held for sale after the approval of our Board of Directors, after an active program to sell the asset has commenced and if the sale is probable. One of the deciding factors in determining whether a sale is probable is whether the firm purchase commitment is obtained and whether the sale is probable within the year. Upon the classification of a real estate asset as held for sale, the carrying value of the asset is reduced to the lower of its net book value or its estimated fair value, less costs to sell the asset. Subsequent to the classification of assets as held for sale, no further depreciation expense is recorded. Real estate assets held for sale are stated separately on the accompanying Consolidated Balance Sheets. Upon a decision that the sale is no longer probable, the asset is classified as an operating asset and depreciation expense is reinstated. The operating results of real estate assets held for sale and sold are reported as discontinued operations in the accompanying Consolidated Statements of Operations. Income from discontinued operations includes the revenues and expenses, including depreciation and interest expense, associated with the assets. This classification of operating results as discontinued operations applies retroactively for all periods presented. Additionally, gains and losses on assets designated as held for sale are classified as part of discontinued operations.

Cost Capitalization

Costs related to planning, developing, leasing and constructing a property are capitalized and classified as Real Estate in the Consolidated Balance Sheets. We capitalize interest to qualifying assets under development based on average accumulated expenditures outstanding during the period. In capitalizing interest to qualifying assets, we first use the interest incurred on specific project debt, if any, and next use the weighted average interest rate of non-project specific debt. We capitalize interest, real estate taxes and certain operating expenses until building construction is substantially complete and the building is ready for its intended use, but no later than one year from the cessation of major construction activity.

We capitalize leasing costs which include commissions paid to outside brokers, legal costs incurred to negotiate and document a lease agreement and any internal costs that may be applicable. We allocate these costs to individual tenant leases and amortize them over the related lease term.

Fair Value Measurement

We apply the guidance in ASC Topic 820, “Fair Value Measurements and Disclosures”, to the valuation of real estate assets. These provisions define fair value as the price that would be received to sell an asset or paid to transfer a liability in a transaction between market participants at the measurement date, establish a hierarchy that prioritizes the information used in developing fair value estimates and require disclosure of fair value measurements by level within the fair value hierarchy. The hierarchy gives the highest priority to quoted prices in active markets (Level 1 measurements) and the lowest priority to unobservable data (Level 3 measurements), such as the reporting entity’s own data.

The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date and includes three levels defined as follows:

- Level 1 Unadjusted quoted prices for identical and unrestricted assets or liabilities in active markets.
- Level 2 Quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3 Unobservable inputs that are significant to the fair value measurement.

A financial instrument’s categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Related Parties

We apply ASC Topic 805, “Business Combinations”, to evaluate business relationships. Related parties are persons or entities who have one or more of the following characteristics, which include entities for which investments in their equity securities would be required, trust for the benefit of persons including principal owners of the entities and members of their immediate families, management personnel of the entity and members of their immediate families and other parties with which the entity may deal if one party controls or can significantly influence the decision making of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests, or affiliates of the entity.

Newly Issued Accounting Standards

We have considered all other newly issued accounting guidance that is applicable to our operations and the preparation of our Consolidated Financial Statements, including that which we have not yet adopted. We do not believe that any such guidance will have a material effect on our financial position or results of operations.

NOTE 2. REAL ESTATE ACTIVITY

Below is a summary of the real estate owned as of March 31, 2014 (dollars in thousands):

Apartments	\$436,109
Commercial properties	178,579
Land held for development	156,272
Real estate held for sale	37,069
Real estate subject to sales contract	25,371
Total real estate	\$833,400
Less accumulated depreciation	(149,786)
Total real estate, net of depreciation	\$683,614

The highlights of our significant real estate transactions for the three months ended March 31, 2014 are listed below:

On February 6, 2014, TCI sold a 232-unit apartment complex known as Pecan Pointe located in Temple, Texas for a sales price of \$23.1 million to an independent third party. The buyer assumed the existing debt of \$16.5 million secured by the property. A gain of \$6.1 million was recorded on the sale.

On March 26, 2014, TCI sold 6.314 acres of land known as McKinney Ranch land located in McKinney, Texas to an independent third party, for a sales price of \$1.7 million. We paid \$1.5 million on the existing mortgage to satisfy a portion of the multi-tract collateral debt of \$6.6 million, secured by various land parcels located in McKinney, Texas. A gain of \$0.8 million was recorded on the land parcel sale.

On March 31, 2014, the Company purchased 16.87 acres of land known as Valwood Acres located in Farmers Branch, Texas from an independent third party for a purchase price of \$3.2 million.

In December 2010, various commercial and land holdings were sold to FRE Real Estate, Inc., a related party. During the first three months of 2011, many of these transactions were rescinded as of the original transaction date and were subsequently sold to related parties under the same ownership as FRE Real Estate, Inc. As of March 31, 2014, one commercial building, Thermalloy, remains in FRE Real Estate, Inc. The Company did not recognize or record the sale in accordance with ASC 360-20 due to TCI's continuing involvement, which included the potential payment of cash shortfalls, future obligations under the existing mortgage and guaranty, the buyer's inadequate initial investment and the Company's questionable recovery of investment cost. The Company determined that no sale had occurred for financial reporting purposes and therefore the asset remained on the books and continued to record operating expenses and depreciation as a period cost until a sale occurred that met the requirements of ASC 360-20.

The properties that we have sold to a related party and have deferred the recognition of the sale are treated as "subject to sales contract" on the Consolidated Balance Sheets. These properties were sold to a related party in order to help facilitate an appropriate debt or organizational restructure and may or may not be transferred back to the seller upon resolution. These properties have mortgages that are secured by the property and many have corporate guarantees. According to the loan documents, the maker is currently in default on these mortgages primarily due to lack of payment and is actively involved in discussions with every lender in order to settle or cure the default situation. We

have reviewed each asset and taken impairment to the extent we feel the value of the property was less than our current basis.

As of March 31, 2014, there remains one apartment complex, one commercial building and 151 acres of land that TCI has sold to a related party and has deferred the recognition of the sale. These are treated as “subject to sales contract” on the Consolidated Balance Sheets. These properties were sold to a related party in order to help facilitate an appropriate debt or organizational restructure and may or may not be transferred back to the seller upon resolution. These properties have mortgages that are secured by the property and many have corporate guarantees. According to the loan documents, the maker is currently in default on these mortgages primarily due to lack of payment and is actively involved in discussions with every lender in order to settle or cure the default situation. TCI has reviewed each asset and taken impairment to the extent it feels the value of the property was less than its current basis. TCI did not recognize or record the sale in accordance with ASC 360-20 due to our continuing involvement, which included the potential payment of cash shortfalls, future obligations under the existing mortgage and guaranty, the buyer’s inadequate initial investment and TCI’s questionable recovery of investment cost. TCI determined that no sale had occurred for financial reporting purposes and therefore the asset remained on the books and continued to record operating expenses and depreciation as a period cost until a sale occurred that met the requirements of ASC 360-20. The buyers received no compensation for the facilitation of the bankruptcy or debt restructuring process.

We continue to invest in the development of apartment projects. During the three months ended March 31, 2014, we have expended \$0.2 million related to the construction or predevelopment of various apartment complexes.

NOTE 3. NOTES AND INTEREST RECEIVABLE

A portion of our assets are invested in mortgage notes receivable, principally secured by real estate. We may originate mortgage loans in conjunction with providing purchase money financing of property sales. Notes receivable are generally collateralized by real estate or interests in real estate and personal guarantees of the borrower and, unless noted otherwise, are so secured. Management intends to service and hold for investment the mortgage notes in our portfolio. A majority of the notes receivable provide for principal to be paid at maturity. Our mortgage notes receivable consist of first, wraparound and junior mortgage loans (dollars in thousands):

Borrower Performing loans:	Maturity Date	Interest Rate	Amount	Security
Miscellaneous non-related party notes	Various	Various	\$ 3,297	Various secured interests
Miscellaneous related party notes (1)	Various	Various	3,441	Various secured interests
One Realco Corporation (1) (2)	01/17	3.00%	7,000	Unsecured
Realty Advisors Management, Inc. (1)	12/16	2.20%	20,387	Unsecured
S Breeze I-V, LLC	06/14	5.00%	3,238	6% Class A and 25% Class B Limited Partner Interests
Woodhaven-Hawthorn, Inc. (1)	10/19	5.50%	1,028	Unsecured
Unified Housing Foundation, Inc. (Cliffs of El Dorado) (1)	12/32	12.00%	2,097	100% Membership Interest in Unified Housing of McKinney, LLC
Unified Housing Foundation, Inc. (Echo Station) (1)	12/32	12.00%	1,481	100% Membership Interest in Unified Housing of Temple, LLC
Unified Housing Foundation, Inc. (Inwood on the Park) (1)	12/32	12.00%	5,059	100% Membership Interest in Unified Housing Inwood, LLC
Unified Housing Foundation, Inc. (Kensington Park) (1)	12/32	12.00%	3,936	100% Membership Interest in Unified Housing Kensington, LLC
Unified Housing Foundation, Inc. (Lakeshore Villas) (1)	12/32	12.00%	2,000	Unsecured
Unified Housing Foundation, Inc. (Lakeshore Villas) (1)	12/32	12.00%	9,096	Membership interest in Housing for Seniors of Humble, LLC
Unified Housing Foundation, Inc. (Limestone Canyon) (1)	12/32	12.00%	3,057	100% Membership Interest in Unified Housing of Austin, LLC
Unified Housing Foundation, Inc. (Limestone Canyon) (1)	12/32	12.00%	4,663	100% Membership Interest in Unified Housing of Austin, LLC
Unified Housing Foundation, Inc. (Limestone Ranch) (1)	12/32	12.00%	2,250	100% Membership Interest in Unified Housing of Vista Ridge, LLC
Unified Housing Foundation, Inc. (Limestone Ranch) (1)	12/32	12.00%	6,000	100% Membership Interest in Unified Housing of Vista Ridge, LLC

Edgar Filing: AMERICAN REALTY INVESTORS INC - Form 10-Q

Unified Housing Foundation, Inc. (Parkside Crossing) (1)	12/32	12.00%	2,272	100% Membership Interest in Unified Housing of Parkside Crossing, LLC
Unified Housing Foundation, Inc. (Sendero Ridge) (1)	12/32	12.00%	5,174	100% Membership Interest in Unified Housing of Sendero Ridge, LLC
Unified Housing Foundation, Inc. (Sendero Ridge) (1)	12/32	12.00%	4,812	100% Membership Interest in Unified Housing of Sendero Ridge, LLC
Unified Housing Foundation, Inc. (Timbers at the Park) (1)	12/32	12.00%	1,323	100% Membership Interest in Unified Housing of Terrell, LLC
Unified Housing Foundation, Inc. (Tivoli) (1)	12/32	12.00%	7,966	100% Membership Interest in Unified Housing of Tivoli, LLC
Unified Housing Foundation, Inc. (Reserve at White Rock Phase I) (1)	12/32	12.00%	2,485	100% Membership Interest in Unified Housing of Harvest Hill I, LLC
Unified Housing Foundation, Inc. (Reserve at White Rock Phase II) (1)	12/32	12.00%	2,555	100% Membership Interest in Unified Housing of Harvest Hill, LLC
Unified Housing Foundation, Inc. (Trails at White Rock) (1)	12/32	12.00%	3,815	100% Membership Interest in Unified Housing of Harvest Hill III, LLC
Unified Housing Foundation, Inc. (1)	12/13	5.00%	6,000	Unsecured
Unified Housing Foundation, Inc. (1)	12/15	12.00%	17,928	Unsecured
Unified Housing Foundation, Inc. (1)	12/16	12.00%	3,657	Unsecured
Foundation for Better Housing, Inc. (Preserve at Pecan Pointe) (1)	03/19	12.00%	1,810	Unsecured
Foundation for Better Housing, Inc. (Preserve at Pecan Pointe) (1)	03/17	12.00%	1,156	Unsecured
Accrued interest			6,687	
Total Performing			\$ 145,670	
Non-Performing loans:				
Leman Development, Ltd (2)	07/11	7.00%	1,500	Unsecured
Tracy Suttles (2)	12/11	0.00%	1,077	Unsecured
Miscellaneous non-related party notes	Various	Various	507	Various secured interests
Accrued interest			45	
Total Non-Performing			\$ 3,129	
				(19,579)

Allowance for doubtful accounts	
Total	\$ 129,220

(1) Related party
notes

(2) An allowance was taken for estimated
losses at full value of note

At March 31, 2014, we had junior mortgage loans and accrued interest receivable from related parties, net of allowances, totaling \$122.3 million. We recognized interest income of \$3.1 million related to these notes receivables.

The Company has various notes receivable from Unified Housing Foundation, Inc. ("UHF"). UHF is determined to be a related party to the Company due to our significant investment in the performance of the collateral secured under the notes receivable. Payments are due from surplus cash flow of operations. Sale or refinance of any of the properties underlying these notes will be used to repay outstanding interest and principal for the remaining notes. These notes are cross-collateralized but to the extent cash is received from a specific UHF property, it is applied against any outstanding interest for the related-property note. The allowance on the UHF notes was a purchase allowance that was netted against the notes when acquired.

On March 31, 2014, TCI received \$4.0 million of notes and accrued interest receivable from Foundation for Better Housing, Inc. (“FBH”). The notes accrue interest at 12%. Of these receivables, \$0.8 million will mature in December 2015, \$1.4 million in March 2017 and \$1.8 million in March 2019.

NOTE 4. INVESTMENT IN UNCONSOLIDATED INVESTEEES

Investments in unconsolidated investees in which we have a 20% to 50% interest or otherwise exercise significant influence are carried at cost and adjusted for the Company’s proportionate share of their undistributed earnings or losses under the equity method of accounting.

Investments in unconsolidated investees consist of the following:

	Percentage ownership as of			
	March 31, 2014		March 31, 2013	
Gruppa Fiorentina, LLC	20.00	%	20.00	%

Gruppa Fiorentina, LLC is the sole member of Milano Restaurants International Corporation, (“Milano”) which operates 35 pizza parlors under the trade name “Me-N-Ed’s Pizza Parlors” located primarily in Central and Northern California. Milano has a 100% ownership interest in SienaCorp, which operates two grills under the trade names “Me-N-Ed’s Victory Grill” and “Me-N-Ed’s Coney Island Grill”. Milano has a 100% ownership interest in Piazza del Pane, Inc., which operates two restaurants located in Central California. Milano also has 23 franchised locations, including two operating, under the trade name Angelo & Vito’s Pizzerias.

The following is a summary of the financial position and results of operations from our investees (dollars in thousands):

As of March 31,	2014	2013
Real estate, net of accumulated depreciation	\$10,518	\$11,313
Notes receivable	6,730	6,170
Other assets	31,026	30,786
Notes payable	(10,473)	(12,429)
Other liabilities	(7,402)	(6,835)
Shareholders' equity	(30,399)	(29,005)
For the Three Months Ended March 31,	2014	2013
Revenue	\$11,626	\$11,141
Depreciation	(288)	(294)
Operating expenses	(10,669)	(10,139)
Interest expense	(227)	(270)
Income from continuing operations	442	438
Income from discontinued operations	-	-
Net income	\$442	\$438
Company's proportionate share of earnings (1)	\$88	\$88

(1) Earnings represents continued and discontinued operations

NOTE 5. NOTES PAYABLE

Below is a summary of our notes and interest payable as of March 31, 2014 (dollars in thousands):

	Notes Payable	Accrued Interest	Total Debt
Apartments	\$367,395	\$1,233	\$368,628
Commercial	102,594	285	102,879
Land	90,621	117	90,738
Real estate held for sale	15,717	-	15,717
Real estate subject to sales contract	19,453	1,538	20,991
Other	67,087	32	67,119
Total	\$662,867	\$3,205	\$666,072

With respect to the additional notes payable due to the acquisition of properties or refinancing of existing mortgages, a summary of some of the more significant transactions is discussed below:

On February 10, 2014, a subsidiary of the Company paid off an existing margin loan and entered into a \$4 million promissory note with a third party, secured by TCI stock. The note matures on February 10, 2016 and has an interest rate of 6%.

On February 12, 2014, TCI exercised the first prepayment option on the settlement relating to the Amoco Building and paid \$1.2 million to settle all obligations. The remaining balance of the note in the amount of \$3.5 million, along with accrued interest, was forgiven. The 135,000 shares of Series K Convertible Preferred Stock of ARL that was pledged to the lender has been released to TCI.

On February 14, 2014, the Company entered into a settlement and loan modification agreement with the lender regarding EQK Portage land. The new loan is for \$1.6 million, matures on February 6, 2017 and has an interest rate of one-month LIBOR plus 5%. The Company paid \$200,000 at close which was used to adjust the current outstanding loan balance to the newly stated loan balance and the remainder was used to pay down interest that had been accruing under the prior agreement. The rest of the unpaid interest that accrued under the prior agreement was waived. Per the agreement, the Company was also required to pay off the property tax note of \$257,000.

On February 28, 2014, TCI refinanced the existing mortgage on Parc at Denham Springs apartments, a 224-unit complex located in Denham Springs, LA, for a new mortgage of \$19.2 million. TCI paid off the existing mortgage of \$19.2 million and \$1.6 million in closing costs. The note accrues interest at 3.75% and payments of interest and principal are due monthly, maturing April 1, 2051.

On March 25, 2014, TCI exercised its lender granted option under the settlement agreement relating to the Galleria East Center Retail / Showcase Chevrolet land which was transferred to the existing lender on February 4, 2011. TCI paid the balance of the notes along with all accrued and unpaid interest and received a reduction in price of \$0.4 million.

On March 28, 2014, TCI secured financing of \$40.0 million from an independent third party. The note has a term of five years at an interest rate of 12.0%. The note is interest only for the first year with quarterly principal payments due of \$500,000 starting April 1, 2015. The loan is secured by various equity interests in residential apartments.

On March 31, 2014, TCI entered into a settlement agreement relating to the Fenton Centre building which was transferred to the existing lender on June 7, 2011. The total amount of the settlement was \$7.0 million, \$5.0 million was paid at the time of the settlement and the remaining \$2.0 million will be paid out in equal monthly installments through November 5, 2015.

There are various land mortgages, secured by the property, that are in the process of a modification or extension to the original note due to expiration of the loan. We are in constant contact with these lenders, working together in order to modify the terms of these loans and we anticipate a timely resolution that is similar to the existing agreement or subsequent modification.

The properties that we have sold to a related party and have deferred the recognition of the sale are treated as “subject to sales contract” on the Consolidated Balance Sheets. These properties were sold to a related party in order to help facilitate an appropriate debt or organizational restructure and may or may not be transferred back to the seller upon resolution. These properties have mortgages that are secured by the property and many have corporate guarantees. According to the loan documents, the maker is currently in default on these mortgages primarily due to lack of payment and is actively involved in discussions with every lender in order to settle or cure the default situation. We have reviewed each asset and taken impairment to the extent we feel the value of the property was less than our current basis.

NOTE 6. RELATED PARTY TRANSACTIONS

The following table reconciles the beginning and ending balances of accounts receivable from and (accounts payable) to related parties as of March 31, 2014 (dollars in thousands):

		Pillar
Related party receivable, December 31, 2013	\$	14,086
Cash transfers		27,227
Advisory fees		(2,242)
Fees and commissions		(392)
Cost reimbursements		(873)
Interest (to) from advisor		147
Net income fee		(490)
Expenses paid by Advisor		(529)
Financing (mortgage payments)		(2,076)
Sales/purchases transactions		(107)
Related party receivable, March 31, 2014	\$	34,751

During the ordinary course of business, we have related party transactions that include, but are not limited to, rent income, interest income, interest expense, general and administrative costs, commissions, management fees and property expenses. In addition, we have assets and liabilities that include related party amounts. The related party amounts included in assets and liabilities, and the related party revenues and expenses received/paid are shown on the face of the financial statements.

NOTE 7. OPERATING SEGMENTS

Our segments are based on our method of internal reporting which classifies our operations by property type. Our property types are grouped into commercial, apartments, hotels, land and other operating segments. Significant differences among the accounting policies of the operating segments as compared to the Consolidated Financial Statements principally involve the calculation and allocation of administrative and other expenses. Management evaluates the performance of each of the operating segments and allocates resources to them based on their net operating income and cash flow.

Items of income that are not reflected in the segments are interest, other income, gain on debt extinguishment, gain on condemnation award, equity in partnerships, and gains on sale of real estate. Expenses that are not reflected in the segments are provision for losses, advisory, net income and incentive fees, general and administrative, non-controlling interests and net loss from discontinued operations before gains on sale of real estate.

The segment labeled as "Other" consists of revenue and operating expenses related to the notes receivable and corporate debt.

Edgar Filing: AMERICAN REALTY INVESTORS INC - Form 10-Q

Presented below is our reportable segments' operating income for the three months ended March 31, 2014 and 2013, including segment assets and expenditures (dollars in thousands):

For the Three Months Ended	Commercial					Total
	Properties	Apartments	Hotels	Land	Other	
March 31, 2014						
Rental and other property revenues	\$ 4,892	\$ 15,681	\$-	\$-	\$ 10	\$ 20,583
Property operating expenses	3,205	6,796	-	311	5	10,317
Depreciation	1,820	2,691	-	-	(35)	4,476
Mortgage and loan interest	1,486	4,196	-	1,050	1,742	8,474
Deferred borrowing costs amortization	13	888	-	35	3	939
Loan charges and prepayment penalties	9	1,573	-	-	-	1,582
Interest income	-	-	-	-	4,117	4,117
Gain on land sales	-	-	-	753	-	753
Segment operating income (loss)	\$(1,641)	\$(463)	\$-	\$(643)	\$ 2,412	\$(335)
Capital expenditures	1,130	-	-	85	-	1,215
Real estate assets	130,838	375,296	-	167,692	-	673,826
Property Sales						
Sales price	\$-	\$ 23,131	\$-	\$ 1,565	\$-	\$ 24,696
Cost of sale	-	17,078	-	812	-	17,890
Gain on sale	\$-	\$ 6,053	\$-	\$ 753	\$-	\$ 6,806
For the Three Months Ended	Commercial					Total
	Properties	Apartments	Hotels	Land	Other	
March 31, 2013						
Rental and other property revenues	\$ 5,377	\$ 14,932	\$-	\$ 34	\$ 7	\$ 20,350
Property operating expenses	3,271	6,365	-	369	(23)	9,982
Depreciation	1,113	2,701	-	-	(59)	3,755
Mortgage and loan interest	1,341	4,665	-	1,536	1,902	9,444
Deferred borrowing costs amortizaion	22	2,342	-	61	36	2,461
Loan charges and prepayment penalties	-	3,937	-	-	-	3,937
Interest income	-	-	-	-	3,541	3,541
Loss on land sales	-	-	-	(35)	-	(35)
Segment operating income (loss)	\$(370)	\$(5,078)	\$-	\$(1,967)	\$ 1,692	\$(5,723)
Capital expenditures	678	31	-	53	-	762
Real estate assets	138,683	385,672	-	209,773	-	734,128
Property Sales						
Sales price	\$-	\$ 25,300	\$-	\$ 2,250	\$-	\$ 27,550

Edgar Filing: AMERICAN REALTY INVESTORS INC - Form 10-Q

Cost of sale	-	18,073	-	2,285	-	20,358
Gain (loss) on sale	\$-	\$7,227	\$-	\$(35) \$-	\$7,192

The table below reconciles the segment information to the corresponding amounts in the Consolidated Statements of Operations:

	For the Three Months Ended March 31,	
	2014	2013
Segment operating loss	\$ (335)	\$ (5,723)
Other non-segment items of income (expense)		
General and administrative	(1,994)	(2,012)
Net income fee to related party	(490)	(56)
Advisory fee to related party	(2,242)	(2,554)
Other income	178	2,536
Loss on sale of investments	-	(8)
Earnings from unconsolidated investees	70	213
Litigation settlement	3,839	(45)
Income tax benefit	1,870	2,673
Net income (loss) from continuing operations	\$ 896	\$ (4,976)

The table below reconciles the segment information to the corresponding amounts in the Consolidated Balance Sheets:

	March 31,	
	2014	2013
Segment assets	\$ 673,826	\$ 734,128
Investments in unconsolidated investees	3,990	10,089
Notes and interest receivable	129,220	101,697
Other assets	133,120	244,505
Total assets	\$ 940,156	\$ 1,090,419

NOTE 8. DISCONTINUED OPERATIONS

We apply the provisions of ASC Topic 360, "Property, Plant and Equipment". ASC Topic 360 requires that long-lived assets that are to be disposed of by sale be measured at the lesser of (1) book value or (2) fair value less cost to sell. In addition, it requires that one accounting model be used for long-lived assets to be disposed of by sale and broadens the presentation of discontinued operations to include more disposal transactions.

Discontinued operations relates to properties that were either sold or held for sale as of the period ended March 31, 2014. Included in discontinued operations are a total of two and 17 properties for 2014 and 2013, respectively. Properties sold in 2014 have been reclassified to discontinued operations for current and prior year reporting periods. In 2014, we sold one apartment complex (Pecan Pointe) and have one commercial property held for sale (1010 Common). In 2013, we sold 11 apartment complexes (Dorado Ranch, Huntington Ridge, Laguna Vista, Legends of El Paso, Mariposa Villas, Paramount Terrace, River Oaks, Savoy of Garland, Stonebridge at City Park, Verandas at City View and Vistas of Pinnacle Park) and four commercial properties (225 Baronne, Amoco, Ergon and Eton Square). The gain on sale of the properties is also included in discontinued operations for those years. The following table summarizes revenue and expense information for the properties sold and held for sale (dollars in thousands):

	For the Three Months Ended March 31,	
	2014	2013
Revenues:		
Rental and other property revenues	\$ 1,147	\$ 8,949
	1,147	8,949
Expenses:		
Property operating expenses	928	4,457
Depreciation	166	269
General and administrative	164	1,432
Total operating expenses	1,258	6,158
Other income (expense):		
Other income	37	-
Mortgage and loan interest	(310)	(2,272)
Deferred borrowing costs amortization	(281)	(18)
Loan charges and prepayment penalties	-	(45)
Litigation settlement	(45)	(45)
Total other expenses	(599)	(2,380)
Loss from discontinued operations before gain on sale of real estate and tax	(710)	411

Edgar Filing: AMERICAN REALTY INVESTORS INC - Form 10-Q

Gain on sale of real estate from discontinued operations	6,053		7,227	
Income tax expense	(1,870)	(2,673)
Income from discontinued operations	\$	3,473	\$	4,965

Our application of ASC Topic 360 results in the presentation of the net operating results of these qualifying properties sold or held for sale during 2014 as income from discontinued operations. This does not have an impact on net income available to common shareholders and only impacts the presentation of these properties within the Consolidated Statements of Operations.

NOTE 9. COMMITMENTS AND CONTINGENCIES AND LIQUIDITY

LK-FOUR HICKORY, LLC

In conjunction with its sale of Four Hickory in November 2007, the Company agreed to fund amounts to satisfy its commitment to compensate LK-Four Hickory, LLC for move-in discounts and other concessions to existing tenants at the time of sale. The Company also has various agreements with LK-Four Hickory, LLC related to the funding of projection shortfalls, which, to date, they have not had to provide any additional funding. In addition, related parties of the Company have active lease agreements with LK-Four Hickory, LLC and the Company has since guaranteed amounts related to certain of these leases.

On December 17, 2007, both Limkwang Nevada, Inc., the majority owner of LK-Four Hickory, LLC and ARL unconditionally guaranteed the punctual payment when due, whether at stated maturity, by acceleration or hereafter, including all fees and expenses incurred by the bank on collection of a \$28.0 million note payable for LK-Four Hickory, LLC which has a current outstanding balance of \$23.4 million.

The Company's investment in LK-Four Hickory, LLC at January 17, 2012 was sold and the Company has additional reserves for estimated potential amounts it could be liable for if various related parties are not able to meet their obligations to LK-Four Hickory, LLC. The Company will continue to evaluate these potential estimates and also the likelihood of having to fund any of these and adjust their reserves accordingly.

Liquidity. Management believes that ARL will generate excess cash flow from property operations in 2014; such excess, however, will not be sufficient to discharge all of ARL's obligations as they became due. Management intends to sell land and income-producing real estate, refinance real estate and obtain additional borrowings primarily secured by real estate to meet its liquidity requirements.

Partnership Buyouts. ARL is the limited partner in various partnerships related to the construction of residential properties. As permitted in the respective partnership agreements, ARL intends to purchase the interests of the general and any other limited partners in these partnerships subsequent to the completion of these projects. The amounts paid to buy out the non-affiliated partners are limited to development fees earned by the non-affiliated partners, and are set forth in the respective partnership agreements.

Litigation. The ownership of property and provision of services to the public as tenants entails an inherent risk of liability. Although the Company and its subsidiaries are involved in various items of litigation incidental to and in the ordinary course of its business, in the opinion of management, the outcome of such litigation will not have a material adverse impact upon the Company's financial condition, results of operation or liquidity, unless noted otherwise below.

The Company is involved in, and vigorously defending against, a number of deficiency claims with respect to assets that have been foreclosed by various lenders. Such claims are generally against a consolidated subsidiary as the borrower or the Company as a guarantor of indebtedness or performance. Some of these proceedings may ultimately result in an unfavorable determination for the Company and/or one of its consolidated subsidiaries. While we cannot predict the final result of such proceedings, management believes that the maximum exposure to the Company and its consolidated subsidiaries, if any, will not exceed approximately \$20.0 million in the aggregate and will occur, if at all, in future years.

DISPOSED OF ENTITIES:

ART and ART Midwest, Inc.

While the Company and all entities in which the Company has a direct or indirect equity interest are not parties to or obligated in any way for the outcome, a formerly owned entity (American Realty Trust, Inc.) and its former subsidiary (ART Midwest, Inc.) have been engaged since 1999 in litigation with Mr. David Clapper and entities related to Mr. Clapper (collectively, the “Clapper Parties”). The matter originally involved a transaction in 1998 in which ART Midwest, Inc. was to acquire eight residential apartment complexes from the Clapper Parties. Through the years, a number of rulings, both for and against American Realty Trust, Inc. (“ART”) and ART Midwest, Inc., were issued. In October 2011, a ruling was issued under which the Clapper Parties received a judgment for approximately \$74 million, including \$26 million in actual damages and \$48 million interest. The ruling was against ART and ART Midwest, Inc., but no other entity. During February 2014, the court of Appeals affirmed a portion of the judgment in favor of the Clapper Parties, but also ruled that a double counting of a significant portion of the damages had occurred and remanded the case back to the trial court to recalculate the damage award, as well as pre and post-judgment interest thereon. ART was also a significant owner of a partnership interest in the partnership that was awarded the initial damages in this matter.

In 2005, ART filed suit against a major national law firm over the initial transaction. That action was initially abated while the principle case with the Clapper Parties was pending, but the abatement was recently lifted and the action against the law firm is expected to move forward. The only defendants in the litigation involving the Clapper Parties are ART and ART Midwest, Inc., which, together, had total assets and net worth, as of December 31, 2012, of approximately \$10 million. In January 2012, the Company sold all of the issued and outstanding stock of ART to an unrelated party for a promissory note in the amount of \$10 million. At December 31, 2012, the Company fully reserved and valued such note at zero.

Subsequent to the sale of the ART stock in January 2012, ART instituted a Chapter 11 bankruptcy proceeding in the United States Bankruptcy Court for the Northern District of Texas, Dallas Division. In March 2014, the bankruptcy court dismissed the proceeding.

Management of the Company believes that the Company has no liability for any ultimate judgment in the proceeding involving the Clapper Parties; however, Management of the Company has serious reservations about the current collectability of the \$10 million note and, accordingly, continues to maintain a full reservation of the value of such note at zero

Port Olpenitz

ARL, through a foreign subsidiary, was involved in developing a maritime harbor town on the 420 acre site of the former naval base of Olpenitz in Kappeln, Germany. Disputes with the local partner related to his mismanagement of the project resulted in his being replaced as the managing partner which was followed by a filing for bankruptcy protection in Germany to completely remove him from the project. An insolvency manager was placed in control of the project in order to protect the creditors and as of December 31, 2013, had sold the vast majority of assets (almost all land) of the project. The Company no longer has any financial responsibility for the obligations of the creditors related to the project and has claims filed for loans relating to our investment in the project. Due to the questionable collectability of these loans from the proceeds of the project, the Company has written off the unreserved balance of \$5.3 million in the project. As of December 13, 2013, ARL had filed two lawsuits in Germany to recover funds invested in the project. The lawsuits are against: 1) the former German partner and his company, and 2) against the law firm in Hamburg originally hired to protect ARL's investment in the project. At this time it is unknown how much can be recovered or how successful the litigation will be.

DYNEX CAPITAL, INC.

On February 13, 2013, the Court of Appeals, Fifth District of Texas at Dallas (the "Fifth Court of Appeals") rendered an opinion involving TCI in Case No. 05-04-01358-CV styled Basic Capital Management, Inc., American Realty Trust, Inc., Transcontinental Realty Investors, Inc., Continental Poydras Corp., Continental Common, Inc. and Continental Baronne, Inc. v. Dynex Commercial, Inc. and Dynex Capital, Inc. The case was on appeal from the 68th Judicial District Court of Dallas County, Texas, had previously been appealed to the Fifth Court of Appeals and further appealed to the Supreme Court of the State of Texas which had remanded the instant case back to the Fifth Court of Appeals to address certain issues. The case had its origin with Dynex Commercial making loans to Continental Poydras Corp., Continental Common, Inc. and Continental Baronne, Inc. (subsidiaries of Continental Mortgage & Equity Trust ("CMET"), an entity which merged into TCI in 1999 after the original suit was filed). Under the original loan commitment, \$160,000,000 in loans were to be made to the entities. The loans were conditioned on the execution of a commitment between Dynex Commercial and Basic Capital Management, Inc. ("Basic").

An original trial to a jury resulted in the jury awarding significant damages to Basic for "lost opportunity," awarding damages in "increased costs" and "lost opportunity" damages to ART and damages of \$960,646.28 in "increased costs" and \$11,161,520 for "lost opportunity" damages in favor of TCI and its subsidiaries (a total of \$12,122,166.28). The original Trial Court ignored the jury's findings and entered a "Judgment Notwithstanding the Verdict" ("JNOV") in Dynex's favor; the Fifth Court of Appeals has now ruled that the JNOV was improper because there was sufficient evidence to support the jury's findings. As a result, the Fifth Court of Appeals ordered the Trial Court to enter a new judgment consistent with the jury's original findings.

The Fifth Court of Appeals also determined that TCI was entitled to damages for "lost opportunities" relating to tenant improvements and awarded TCI an additional \$252,577. Issues relating to attorneys fees were also addressed with the Fifth Court of Appeals ordering the Trial Court to "re-try" the issue of attorney's fees to determine the amount of fees to

which TCI would be entitled on a “breach of commitment” claim. In addition, as a result of the changes in amounts awarded and passage of time, the Fifth Court of Appeals also ordered the Trial Court to recalculate the correct amounts of pre and post-judgment interest owed to Appellants.

While the fifteen year old controversy is not yet fully resolved, the Fifth Court of Appeals opinion is favorable to TCI, but TCI expects continued challenges by Dynex to the Fifth Court of Appeals opinion and any ultimate award of damages by the Trial Court.

During the first quarter of the fiscal year covered by this Report, no proceeding previously reported was terminated.

NOTE 10. EARNINGS PER SHARE

Earnings per share (“EPS”) have been computed pursuant to the provisions of ASC Topic 260, “Earnings Per Share”. The computation of basic EPS is calculated by dividing net income available to common shareholders from continuing operations, adjusted for preferred dividends, by the weighted-average number of common shares outstanding during the period. Shares issued during the period shall be weighted for the portion of the period that they were outstanding.

As of March 31, 2014, we have 3,353,954 shares of Series A 10.0% cumulative convertible preferred stock, which are outstanding. These shares may be converted into common stock at 90% of the average daily closing price of the common stock for the prior 20 trading days. These are considered in the computation of diluted earnings per share if the effect of applying the if-converted method is dilutive.

Of the outstanding 3,353,954 shares of Series A 10.0% cumulative convertible preferred stock, 300,000 shares are owned by ART Edina, Inc. and 600,000 shares are owned by ART Hotel Equities, Inc., both wholly owned subsidiaries of ARL. Dividends are not paid on the shares owned by ARL subsidiaries. Realty Advisors, Inc., a related party, owns 2,451,435 shares of the outstanding shares and has accrued dividends unpaid of \$14.5 million.

We have 135,000 shares of Series K Convertible Preferred Stock, which are held by TCI. These shares may be converted into common stock at the rate of five shares of common stock to one share of preferred stock based on the daily closing price of the common stock. These are considered in the computation of diluted earnings per share if the effect of applying the “if-converted” method is dilutive.

As of March 31, 2014, we have 1,000 shares of stock options outstanding, which will expire January 1, 2015 if not exercised. The outstanding options are considered in the computation of diluted earnings per share if the effect of applying the “treasury stock” method is dilutive.

As of March 31, 2014, the preferred stock and the stock options were anti-dilutive and thus not included in the EPS calculation.

NOTE 11. SUBSEQUENT EVENTS

On April 3, 2014, TCI sold 1010 Common, a 512,593 square foot commercial building, located in New Orleans, LA, for a sales price of \$16.6 million. An estimated gain of \$4.1 million will be recorded on the sale.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the financial statements and notes thereto appearing elsewhere in this report.

This Report on Form 10-Q contains forward-looking statements within the meaning of the federal securities laws, principally, but not only, under the captions "Business", "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations". We caution investors that any forward-looking statements in this report, or which management may make orally or in writing from time to time, are based on management's beliefs and on assumptions made by, and information currently available to, management. When used, the words "anticipate", "believe", "expect", "intend", "may", "might", "plan", "estimate", "project", "should", "will", "result" and similar expressions relate solely to historical matters are intended to identify forward-looking statements. These statements are subject to risks, uncertainties, and assumptions and are not guarantees of future performance, which may be affected by known and unknown risks, trends, uncertainties, and factors, that are beyond our control. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, estimated, or projected. We caution you that, while forward-looking statements reflect our good faith beliefs when we make them, they are not guarantees of future performance and are impacted by actual events when they occur after we make such statements. We expressly disclaim any responsibility to update our forward-looking statements, whether as a result of new information, future events or otherwise. Accordingly, investors should use caution in relying on past forward-looking statements, which are based on results and trends at the time they are made, to anticipate future results or trends.

Some of the risks and uncertainties that may cause our actual results, performance or achievements to differ materially from those expressed or implied by forward-looking statements include, among others, the following:

- general risks affecting the real estate industry (including, without limitation, the inability to enter into or renew leases, dependence on tenants' financial condition, and competition from other developers, owners and operators of real estate);
- risks associated with the availability and terms of construction and mortgage financing and the use of debt to fund acquisitions and developments;
- demand for apartments and commercial properties in the Company's markets and the effect on occupancy and rental rates;
- the Company's ability to obtain financing, enter into joint venture arrangements in relation to or self-fund the development or acquisition of properties;
- risks associated with the timing and amount of property sales and the resulting gains/losses associated with such sales;
- failure to manage effectively our growth and expansion into new markets or to integrate acquisitions successfully;
- risks and uncertainties affecting property development and construction (including, without limitation, construction delays, cost overruns, inability to obtain necessary permits and public opposition to such activities);
-

risks associated with downturns in the national and local economies, increases in interest rates, and volatility in the securities markets;

- costs of compliance with the Americans with Disabilities Act and other similar laws and regulations;
 - potential liability for uninsured losses and environmental contamination;
- risks associated with our dependence on key personnel whose continued service is not guaranteed; and
- the other risk factors identified in this Form 10-Q, including those described under the caption “Risk Factors.”

The risks included here are not exhaustive. Some of the risks and uncertainties that may cause our actual results, performance, or achievements to differ materially from those expressed or implied by forward-looking statements, include among others, the factors listed and described at Part I, Item 1A. “Risk Factors” in the Company’s Annual Report on Form 10-K, which investors should review. There have been no changes from the risk factors previously described in the Company’s Form 10-K for the fiscal year ended December 31, 2013.

Other sections of this report may also include suggested factors that could adversely affect our business and financial performance. Moreover, we operate in a very competitive and rapidly changing environment. New risks emerge from time-to-time and it is not possible for management to predict all such matters: nor can we assess the impact of all such matter on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. Given these risks and uncertainties, investors should not place undue reliance on forward-looking statements as prediction of actual results. Investors should also refer to our quarterly reports on Form 10-Q for future periods and to other materials we may furnish to the public from time-to-time through Forms 8-K or otherwise as we file them with the SEC.

Overview

We are an externally advised and managed real estate investment company that owns a diverse portfolio of income-producing properties, and land held for development. Our portfolio of income-producing properties includes residential apartment communities, office buildings, hotels, and other commercial properties. Our investment strategy includes acquiring existing income-producing properties as well as developing new properties on land already owned or acquired for a specific development project. We acquire land primarily in urban in-fill locations or high-growth suburban markets. We are an active buyer and seller of real estate and during the nine months ended March 31, 2014, we sold \$24.8 million of land and income-producing properties. As of March 31, 2014, we owned 6,166 units in 36 residential apartment communities and 10 commercial properties comprising approximately 2.6 million rentable square feet. In addition, we owned 4,209 acres of land held for development.

We finance our acquisitions primarily through operating cash flow, proceeds from the sale of land and income-producing properties, and debt financing primarily in the form of property-specific first-lien mortgage loans from commercial banks and institutional lenders. We finance our development projects principally with short-term, variable interest rate construction loans that are converted to long-term, fixed rate amortizing mortgages when the development project is completed and occupancy has been stabilized. We will, from time to time, also enter into partnerships with various investors to acquire income-producing properties or land and to sell interests in certain of our wholly owned properties. When we sell assets, we may carry a portion of the sales price generally in the form of a short-term, interest bearing seller-financed note receivable. We generate operating revenues primarily by leasing apartment units to residents; leasing office, retail and industrial space to commercial tenants; and renting hotel rooms to guests. We have no employees.

We have historically engaged in and may continue to engage in certain business transactions with related parties, including but not limited to asset acquisition and dispositions. Transactions involving related parties cannot be presumed to be carried out on an arm's length basis due to the absence of free market forces that naturally exist in business dealings between two or more unrelated entities. Related party transactions may not always be favorable to our business and may include terms, conditions and agreements that are not necessarily beneficial to or in our best interest.

Pillar Income Asset Management, Inc. ("Pillar") is the Company's external Advisor and Cash Manager. Although the Board of Directors is directly responsible for managing the affairs of ARL, and for setting the policies which guide it, the day-to-day operations of ARL are performed by Pillar, as the contractual Advisor, under the supervision of the Board. Pillar's duties include, but are not limited to, locating, evaluating and recommending real estate and real estate-related investment opportunities and arranging debt and equity financing for the Company with third party lenders and investors. Additionally, Pillar serves as a consultant to the Board with regard to their decisions in connection with ARL's business plan and investment policy. Pillar also serves as an Advisor and Cash Manager to TCI and IOT.

Regis Realty Prime, LLC ("Regis") manages our commercial properties and provides brokerage services. ARL engages third-party companies to lease and manage its apartment properties. TCI also has a development agreement with Unified Housing Foundation, Inc. ("UHF") a non-profit corporation that provides management services for the development of residential apartment projects in the future. This development agreement was terminated December 31, 2013.

Critical Accounting Policies

We present our financial statements in accordance with generally accepted accounting principles in the United States ("GAAP"). The FASB Accounting Standards Codification ("ASC") is the single source of authoritative accounting

principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with GAAP. As of the effective date, we no longer refer to the authoritative guidance dictating its accounting methodologies under the previous accounting standards hierarchy. Instead, we refer to the ASC Codification as the sole source of authoritative literature.

The accompanying Consolidated Financial Statements include our accounts, our subsidiaries, generally all of which are wholly-owned, and all entities in which we have a controlling interest. Arrangements that are not controlled through voting or similar rights are accounted for as a Variable Interest Entity (“VIE”), in accordance with the provisions and guidance of ASC Topic 810 “Consolidation”, whereby we have determined that we are a primary beneficiary of the VIE and meet certain criteria of a sole general partner or managing member as identified in accordance with Emerging Issues Task Force (“EITF”) Issue 04-5, Investor’s Accounting for an Investment in a Limited Partnership when the Investor is the Sole General Partner and the Limited Partners have Certain Rights (“EITF 04-5”). VIEs are generally entities that lack sufficient equity to finance their activities without additional financial support from other parties or whose equity holders as a group lack adequate decision making ability, the obligation to absorb expected losses or residual returns of the entity, or have voting rights that are not proportional to their economic interests. The primary beneficiary generally is the entity that provides financial support and bears a majority of the financial risks, authorizes certain capital transactions, or makes operating decisions that materially affect the entity’s financial results. All significant intercompany balances and transactions have been eliminated in consolidation.

In determining whether we are the primary beneficiary of a VIE, we consider qualitative and quantitative factors, including, but not limited to: the amount and characteristics of our investment; the obligation or likelihood for us or other investors to provide financial support; our and the other investors' ability to control or significantly influence key decisions for the VIE; and the similarity with and significance to the business activities of us and the other investors. Significant judgments related to these determinations include estimates about the current future fair values and performance of real estate held by these VIEs and general market conditions.

For entities in which we have less than a controlling financial interest or entities where we are not deemed to be the primary beneficiary, the entities are accounted for using the equity method of accounting. Accordingly, our share of the net earnings or losses of these entities are included in consolidated net income. Our investment in Gruppo Florentina, LLC is accounted for under the equity method.

Real Estate

Upon acquisitions of real estate, we assess the fair value of acquired tangible and intangible assets, including land, buildings, tenant improvements, "above-market" and "below-market" leases, origination costs, acquired in-place leases, other identified intangible assets and assumed liabilities in accordance with ASC Topic 805 "Business Combinations", and allocate the purchase price to the acquired assets and assumed liabilities, including land at appraised value and buildings at replacement cost.

We assess and consider fair value based on estimated cash flow projections that utilize appropriate discount and/or capitalization rates, as well as available market information. Estimates of future cash flows are based on a number of factors including the historical operating results, known and anticipated trends, and market and economic conditions. The fair value of the tangible assets of an acquired property considers the value of the property as if it were vacant. We also consider an allocation of purchase price of other acquired intangibles, including acquired in-place leases that may have a customer relationship intangible value, including (but not limited to) the nature and extent of the existing relationship with the tenants, the tenants' credit quality and expectations of lease renewals. Based on our acquisitions to date, our allocation to customer relationship intangible assets has been immaterial.

We record acquired "above-market" and "below-market" leases at their fair values (using a discount rate which reflects the risks associated with the leases acquired) equal to the difference between (1) the contractual amounts to be paid pursuant to each in-place lease and (2) management's estimate of fair market lease rates for each corresponding in-place lease, measured over a period equal to the remaining term of the lease for above-market leases and the initial term plus the term of any below-market fixed rate renewal options for below-market leases.

A variety of costs are incurred in the acquisition, development and leasing of properties. After determination is made to capitalize a cost, it is allocated to the specific component of a project that is benefited. Determination of when a development project is substantially complete and capitalization must cease involves a degree of judgment. Our capitalization policy on development properties is guided by ASC Topic 835-20 "Interest - Capitalization of Interest" and ASC Topic 970 "Real Estate - General". The costs of land and buildings under development include specifically identifiable costs. The capitalized costs include pre-construction costs essential to the development of the property, development costs, construction costs, interest costs, real estate taxes, salaries and related costs and other costs incurred during the period of development. We cease capitalization when a building is considered substantially complete and ready for its intended use, but no later than one year from the cessation of major construction activity.

Other intangible assets acquired include amounts for in-place lease values that are based on our evaluation of the specific characteristics of each tenant's lease. Factors to be considered include estimates of carrying costs during hypothetical expected lease-up periods considering current market conditions, and costs to execute similar leases. In

estimating carrying costs, we include real estate taxes, insurance and other operating expenses and estimates of lost rentals at market rates during the expected lease-up periods, depending on local market conditions. In estimating costs to execute similar leases, we consider leasing commissions, legal and other related expenses.

ASC Topic 360 “Property, Plant and Equipment” requires that qualifying assets and liabilities and the results of operations that have been sold, or otherwise qualify as held for sale, be presented as discontinued operations in all periods presented if the property operations are expected to be eliminated and we will not have significant continuing involvement following the sale. The components of the property’s net income that is reflected as discontinued operations include the net gain (or loss) upon the disposition of the property held for sale, operating results, depreciation and interest expense (if the property is subject to a secured loan). We generally consider assets to be held for sale when the transaction has been approved by our Board of Directors, or a committee thereof, and there are no known significant contingencies relating to the sale, such that the property sale within one year is considered probable. Following the classification of a property as held for sale, no further depreciation is recorded on the assets.

Depreciation and Impairment

Real estate is stated at depreciated cost. The cost of buildings and improvements includes the purchase price of property, legal fees and other acquisition costs. Costs directly related to the development of properties are capitalized. Capitalized development costs include interest, property taxes, insurance, and other project costs incurred during the period of development.

Management reviews its long-lived assets used in operations for impairment when there is an event or change in circumstances that indicates impairment in value. An impairment loss is recognized if the carrying amount of its assets is not recoverable and exceeds its fair value. If such impairment is present, an impairment loss is recognized based on the excess of the carrying amount of the asset over its fair value. The evaluation of anticipated cash flows is highly subjective and is based in part on assumptions regarding future occupancy, rental rates and capital requirements that could differ materially from actual results in future periods.

Investments in Unconsolidated Real Estate Ventures

Except for ownership interests in variable interest entities, we account for our investments in unconsolidated real estate ventures under the equity method of accounting because we exercise significant influence over, but do not control, these entities. These investments are recorded initially at cost, as investments in unconsolidated real estate ventures, and subsequently adjusted for equity in earnings and cash contributions and distributions. Any difference between the carrying amount of these investments on our balance sheet and the underlying equity in net assets is amortized as an adjustment to equity in earnings of unconsolidated real estate ventures over the life of the related asset. Under the equity method of accounting, our net equity is reflected within the Consolidated Balance Sheets, and our share of net income or loss from the joint ventures is included within the Consolidated Statements of Operations. The joint venture agreements may designate different percentage allocations among investors for profits and losses; however, our recognition of joint venture income or loss generally follows the joint venture's distribution priorities, which may change upon the achievement of certain investment return thresholds. For ownership interests in variable interest entities, we consolidate those in which we are the primary beneficiary.

Recognition of Rental Income

Rental income for commercial property leases is recognized on a straight-line basis over the respective lease terms. In accordance with ASC Topic 805 "Business Combinations", we recognize rental revenue of acquired in-place "above-market" and "below-market" leases at their fair values over the terms of the respective leases. On our Consolidated Balance Sheets, we include as a receivable the excess of rental income recognized over rental payments actually received pursuant to the terms of the individual commercial lease agreements.

Reimbursements of operating costs, as allowed under most of our commercial tenant leases, consist of amounts due from tenants for common area maintenance, real estate taxes and other recoverable costs, and are recognized as revenue in the period in which the recoverable expenses are incurred. We record these reimbursements on a "gross" basis, since we generally are the primary obligor with respect to purchasing goods and services from third-party suppliers, have discretion in selecting the supplier and have the credit risk with respect to paying the supplier.

Rental income for residential property leases is recorded when due from residents and is recognized monthly as earned, which is not materially different than on a straight-line basis as lease terms are generally for periods of one year or less. For hotel properties, revenues for room sales and guest services are recognized as rooms are occupied and services are rendered. An allowance for doubtful accounts is recorded for all past due rents and operating expense reimbursements considered to be uncollectible.

Revenue Recognition on the Sale of Real Estate

Sales and the associated gains or losses of real estate are recognized in accordance with the provisions of ASC Topic 360-20, "Property, Plant and Equipment – Real Estate Sale". The specific timing of a sale is measured against various criteria in ASC 360-20 related to the terms of the transaction and any continuing involvement in the form of management or financial assistance associated with the properties. If the sales criteria for the full accrual method are not met, we defer some or all of the gain recognition and account for the continued operations of the property by

applying the finance, leasing, deposit, installment or cost recovery methods, as appropriate, until the sales criteria are met.

Non-Performing Notes Receivable

We consider a note receivable to be non-performing when the maturity date has passed without principal repayment and the borrower is not making interest payments in accordance with the terms of the agreement.

Interest Recognition on Notes Receivable

We record interest income as earned in accordance with the terms of the related loan agreements.

Allowance for Estimated Losses

We assess the collectability of notes receivable on a periodic basis, of which the assessment consists primarily of an evaluation of cash flow projections of the borrower to determine whether estimated cash flows are sufficient to repay principal and interest in accordance with the contractual terms of the note. We recognize impairments on notes receivable when it is probable that principal and interest will not be received in accordance with the contractual terms of the loan. The amount of the impairment to be recognized generally is based on the fair value of the partnership's real estate that represents the primary source of loan repayment. See Note 3 "Notes and Interest Receivable" for details on our notes receivable.

Fair Value of Financial Instruments

We apply the guidance in ASC Topic 820, “Fair Value Measurements and Disclosures”, to the valuation of real estate assets. These provisions define fair value as the price that would be received to sell an asset or paid to transfer a liability in a transaction between market participants at the measurement date, establish a hierarchy that prioritizes the information used in developing fair value estimates and require disclosure of fair value measurements by level within the fair value hierarchy. The hierarchy gives the highest priority to quoted prices in active markets (Level 1 measurements) and the lowest priority to unobservable data (Level 3 measurements), such as the reporting entity’s own data.

The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date and includes three levels defined as follows:

Level

1 – Unadjusted quoted prices for identical and unrestricted assets or liabilities in active markets.

Level 2 – Quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level

3 – Unobservable inputs that are significant to the fair value measurement.

A financial instrument’s categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Related Parties

We apply ASC Topic 805, “Business Combinations”, to evaluate business relationships. Related parties are persons or entities who have one or more of the following characteristics, which include entities for which investments in their equity securities would be required, trust for the benefit of persons including principal owners of the entities and members of their immediate families, management personnel of the entity and members of their immediate families and other parties with which the entity may deal if one party controls or can significantly influence the decision making of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests, or affiliates of the entity.

Results of Operations

The discussion of our results of operations is based on management’s review of operations, which is based on our segments. Our segments consist of apartments, commercial buildings, hotels, land and other. For discussion purposes, we break these segments down into the following sub-categories; same property portfolio, acquired properties, and developed properties in the lease-up phase. The same property portfolio consists of properties that were held by us for the entire period for both years being compared. The acquired property portfolio consists of properties that we acquired but have not been held for the entire period for both periods being compared. Developed properties in the lease-up phase consist of completed projects that are being leased up. As we complete each phase of the project, we lease-up that phase and include those revenues in our continuing operations. Once a developed property becomes leased up and is held the entire period for both periods under comparison, it is considered to be included in the same property portfolio. Income-producing properties that we have sold during the year are reclassified to discontinued operations for all periods presented.

The following discussion is based on our Consolidated Statements of Operations for the three months ended March 31, 2014 and 2013 as included in Part I, Item 1. “Financial Statements” of this report. The prior year’s property

portfolios have been adjusted for subsequent sales. Continuing operations relates to income-producing properties that were held during those years as adjusted for sales in the subsequent years.

At March 31, 2014 and 2013, we owned or had interests in a portfolio of 46 and 61 income-producing properties, respectively. The total property portfolio represents all income-producing properties held as of March 31 for the period presented. Sales subsequent to the period ended represent properties that were held as of the period end for the periods presented, but sold in the next quarter. Continuing operations represents all properties that have not been reclassified to discontinued operations as of March 31, 2014 for the periods presented.

	March 31,	
	2014	2013
Continuing operations	45	45
Held for sale/subsequent sales	1	16
Total property portfolio	46	61

Comparison of the three months ended March 31, 2014 to the same period ended 2013

For the three months ended March 31, 2014, we reported a net income applicable to common shares of \$2.9 million or \$0.25 per diluted earnings per share, as compared to a net loss applicable to common shares of \$0.2 million or \$0.02 per diluted earnings per share for the same period ended 2013.

Revenues

Rental and other property revenues were \$20.6 million for the three months ended March 31, 2014. This represents an increase of \$0.2 million, as compared to the prior period revenues of \$20.4 million. This change, by segment, is an increase in the apartment portfolio of \$0.7 million, offset by a decrease in the commercial portfolio of \$0.5 million. Within the apartment portfolio there was an increase of \$0.7 million in the same property portfolio. Our apartment portfolio continues to thrive in the current economic conditions with occupancies averaging 95%. Our existing commercial portfolio decreased by \$0.5 million in the same store properties. This decrease is due to lost rents from tenant vacancies. We are continuing to market our properties aggressively to attract new tenants and strive for continuous improvement of our properties in order to maintain our existing tenants.

Expense

Property operating expenses were \$10.3 million for the three months ended March 31, 2014. This represents an increase of \$0.3 million, as compared to the prior period operating expenses of \$10.0 million. This change, by segment, is an increase in the apartment portfolio of \$0.4 million, offset by a decrease in the commercial portfolio of \$0.1 million. Within the apartment portfolio, the increase relates to general repair and maintenance expense and real estate taxes.

Depreciation and amortization expense was \$4.5 million for the three months ended March 31, 2014. This represents an increase of \$0.7 million, as compared to the prior period expense of \$3.8 million. This change is attributable to the commercial portfolio due to new assets placed in service in the current period.

Other income (expense)

Interest income was \$4.1 million for the three months ended March 31, 2014. This represents an increase of \$0.6 million, as compared to the prior year income of \$3.5 million. This increase is due to new UHF notes that were acquired in December 2013.

Mortgage and loan interest expense was \$8.5 million for the three months ended March 31, 2014. This represents a decrease of \$0.9 million, as compared to the prior year expense of \$9.4 million. This change by segment, is a decrease in the apartment portfolio of \$0.4 million, a decrease in the land portfolio of \$0.5 million, a decrease in the other portfolio of \$0.1 million, offset by an increase in the commercial portfolio of \$0.1 million. Within the apartment portfolio, the majority of the decrease relates to the same apartment portfolio due to the refinances closed with long-term, low interest rates. The decrease in the land portfolio was due to land sales.

Deferred borrowing costs amortization was \$0.9 million for the three months ended March 31, 2014. This represents a decrease of \$1.6 million as compared to the prior period expense of \$2.5 million. The majority of the decrease is in the same store apartment portfolio due to the write off in the prior period of prior loan deferred borrowing costs upon the refinance into a new mortgage note.

Loan charges and prepayment penalties were \$1.6 million for the three months ended March 31, 2014. This represents a decrease of \$2.3 million, as compared to the prior period expense of \$3.9 million. There were fewer refinances

completed in the current period than in the prior period.

Due to the litigation settlement and the prepayment option relating to the Amoco Building, the outstanding balance of the note was forgiven.

Gain on land sales increased for the three months ended March 31, 2014. In the current period we sold 6.31 acres of land in one transaction for a sales price of \$1.6 million and recorded a gain of \$0.8 million. In the prior period, we sold 28.42 acres of land in two separate transactions for an aggregate sales price of \$2.75 million and recorded a loss of \$0.1 million.

Discontinued operations relates to properties that were either sold or held for sale as of the period ended March 31, 2014. Included in discontinued operations are a total of two and 17 properties for 2014 and 2013, respectively. Properties sold in 2014 have been reclassified to discontinued operations for current and prior year reporting periods. In 2014, we sold one apartment complex (Pecan Pointe) and have one commercial property held for sale (1010 Common). In 2013, we sold 11 apartment complexes (Dorado Ranch, Huntington Ridge, Laguna Vista, Legends of El Paso, Mariposa Villas, Paramount Terrace, River Oaks, Savoy of Garland, Stonebridge at City Park, Verandas at City View and Vistas of Pinnacle Park) and four commercial properties (225 Baronne, Amoco, Ergon and Eton Square). The gain on sale of the properties is also included in discontinued operations for those years. The following table summarizes revenue and expense information for the properties sold and held for sale (dollars in thousands):

	For the Three Months Ended March 31,	
	2014	2013
Revenues:		
Rental and other property revenues	\$ 1,147	\$ 8,949
	1,147	8,949
Expenses:		
Property operating expenses	928	4,457
Depreciation	166	269
General and administrative	164	1,432
Total operating expenses	1,258	6,158
Other income (expense):		
Other income	37	-
Mortgage and loan interest	(310)	(2,272)
Deferred borrowing costs amortization	(281)	(18)
Loan charges and prepayment penalties	-	(45)
Litigation settlement	(45)	(45)
Total other expenses	(599)	(2,380)
Loss from discontinued operations before gain on sale of real estate and tax	(710)	411
Gain on sale of real estate from discontinued operations	6,053	7,227
Income tax expense	(1,870)	(2,673)
Income from discontinued operations	\$ 3,473	\$ 4,965

Liquidity and Capital Resources

Our principal liquidity needs are:

- fund normal recurring expenses;
- meet debt service and principal repayment obligations including balloon payments on maturing debt;
- fund capital expenditures, including tenant improvements and leasing costs;
- fund development costs not covered under construction loans; and
- fund possible property acquisitions.

Our principal sources of cash have been and will continue to be:

- property operations;
- proceeds from land and income-producing property sales;
- collection of mortgage notes receivable;
- collection of receivables from related party companies;
- refinancing of existing debt; and
- additional borrowing, including mortgage notes payable and lines of credit.

We draw on multiple financing sources to fund our long-term capital needs. We generally fund our development projects with construction loans. Management anticipates that our available cash from property operations may not be sufficient to meet all of our cash requirements. Management intends to selectively sell land and income-producing assets, refinance or extend real estate debt and seek additional borrowing secured by real estate to meet its liquidity requirements. Although the past cannot predict the future, historically, management has been successful at extending a portion of our current maturity obligations and selling assets as necessary to meet current obligations.

Cash Flow Summary

The following summary discussion of our cash flows is based on the statements of cash flows as presented in Part I Item 1. "Financial Statements" and is not meant to be an all-inclusive discussion of the changes in our cash flow (dollars in thousands):

	March 31,		
	2014	2013	Variance
Net cash used in operating activities	\$(15,187)	\$(9,070)	\$(6,117)
Net cash provided by investing activities	\$14,518	\$23,733	\$(9,215)
Net cash provided by (used in) financing activities	\$2,616	\$(23,542)	\$26,158

Our primary use of cash for operations is daily operating costs, general and administrative expenses, advisory fees and land holding costs. Our primary source of cash from operating activities is from rental income on properties. In addition, we have a related party account in which excess cash is transferred to or from. We received more interest payments from our notes receivables in the current period and used more cash to pay down related party payables and other payables than in the prior period.

Our primary cash outlays for investing activities are for construction and development, acquisition of land and income-producing properties, and capital improvements to existing properties. Our primary sources of cash from investing activities are from the proceeds on the sale of land and income-producing properties. Sales in the current period were consistent with the prior period. The majority of the decrease is related to the acquisition of notes receivables and land held for development.

Our primary sources of cash from financing activities are from proceeds on notes payables either through refinancing our existing loans or by obtaining new financing. Our primary cash outlays are for recurring debt payments and payments on maturing notes payable. Proceeds from notes payable associated with new loans and refinancing provided more cash in the current period to be used in operations.

Environmental Matters

Under various federal, state and local environmental laws, ordinances and regulations, we may be potentially liable for removal or remediation costs, as well as certain other potential costs relating to hazardous or toxic substances (including governmental fines and injuries to persons and property) where property-level managers have arranged for the removal, disposal or treatment of hazardous or toxic substances. In addition, certain environmental laws impose liability for release of asbestos-containing materials into the air, and third parties may seek recovery for personal injury associated with such materials.

Management is not aware of any environmental liability relating to the above matters that would have a material adverse effect on our business, assets or results of operations.

Inflation

The effects of inflation on our operations are not quantifiable. Revenues from property operations tend to fluctuate proportionately with inflationary increases and decreases in real estate costs. Fluctuations in the rate of inflation also affect the sales values of properties and the ultimate gains to be realized from property sales. To the extent that inflation affects interest rates, earnings from short-term investments and the cost of new financings as well as the cost of variable interest rate debt will be affected.

Tax Matters

During the third quarter 2012, Realty Advisors Management, Inc. (“RAMI”) subsidiaries acquired stock of ARL such that more than 80% of ARL was owned by the RAMI group. As a result, ARL joined the RAMI consolidated group for federal income tax reporting.

Financial statement income varies from taxable income principally due to the accounting for income and losses of investees, gains and losses from asset sales, depreciation on owned properties, amortization of discounts on notes receivable and payable and the difference in the allowance for estimated losses. ARL had a loss for federal income tax purposes after the use of net operating loss carryforwards in the first three months of 2014 and a loss in 2013 and 2012, therefore, it recorded no provision for income taxes.

At March 31, 2014, ARL had a net deferred tax asset of \$122.9 million due to tax deductions available to it in future years. However, as management cannot determine that it is more likely than not that ARI will realize the benefit of the deferred tax assets, a 100% valuation allowance has been established.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

At March 31, 2014, our exposure to a change in interest rates on our debt is as follows (dollars in thousands, except per share):

	Balance	Weighted Average Interest Rate	Effect of 1% Increase In Base Rates
Notes payable:			
Variable rate	\$59,169	4.73	% \$ 592
Total decrease in ARL's annual net income			592
Per share			\$ 0.05

ITEM 4. CONTROLS AND PROCEDURES

Based on an evaluation by our management (with the participation of our Principal Executive Officer and Principal Financial Officer), as of the end of the period covered by this report, our Principal Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), were effective to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms and that such information is accumulated and communicated to our management, including our Principal Executive Officer and Principal Financial Officer, to allow timely decisions regarding required disclosures.

There has been no change in our internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)) during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

On September 1, 2000, the Board of Directors approved a share repurchase program authorizing the repurchase of up to a total of 1,000,000 shares of ARL common stock. This repurchase program has no termination date. In August 2010, the Board of Directors approved an increase in the share repurchase program for up to an additional 250,000 shares of Common Stock which results in a total authorization under the repurchase program for up to 1,250,000 shares. The following table represents shares repurchased on a monthly basis during the first quarter of 2014:

Period	Total Number of Shares Purchased	Average Price Paid per share	Total Number of Shares Purchased as Part of Publicly Announced Program	Maximum Number of Shares that May Yet be Purchased Under the Program
Balance at December 31, 2013			986,750	263,250
January 31, 2014	-	\$ -	986,750	263,250
February 28, 2014	-	\$ -	986,750	263,250
March 31, 2014	-	\$ -	986,750	263,250
Total	-			

ITEM 6. EXHIBITS

The following exhibits are filed herewith or incorporated by reference as indicated below:

Exhibit

Number Description of Exhibit

- 3.0 Certificate of Restatement of Articles of Incorporation of American Realty Investors, Inc. dated August 3, 2000 (incorporated by reference to Exhibit 3.0 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2000).
- 3.1 Certificate of Correction of Restated Articles of Incorporation of American Realty Investors, Inc. dated August 29, 2000 (incorporated by reference to Exhibit 3.1 to Registrant's Quarterly Report on Form 10-Q dated September 30, 2000).
- 3.2 Articles of Amendment to the Restated Articles of Incorporation of American Realty Investors, Inc. decreasing the number of authorized shares of and eliminating Series B Cumulative Convertible Preferred Stock dated August 23, 2003 (incorporated by reference to Exhibit 3.3 to Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003).
- 3.3 Articles of Amendment to the Restated Articles of Incorporation of American Realty Investors, Inc., decreasing the number of authorized shares of and eliminating Series I Cumulative Preferred Stock dated October 1, 2003 (incorporated by reference to Exhibit 3.4 to Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2003).
- 3.4 Bylaws of American Realty Investors, Inc. (incorporated by reference to Exhibit 3.2 to Registrant's Registration Statement on Form S-4 filed December 30, 1999).
- 4.1 Certificate of Designations, Preferences and Relative Participating or Optional or Other Special Rights, and Qualifications, Limitations or Restrictions Thereof of Series F Redeemable Preferred Stock of American Realty Investors, Inc., dated June 11, 2001 (incorporated by reference to Exhibit 4.1 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2001).
- 4.2 Certificate of Withdrawal of Preferred Stock, Decreasing the Number of Authorized Shares of and Eliminating Series F Redeemable Preferred Stock, dated June 18, 2002 (incorporated by reference to Exhibit 3.0 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002).
- 4.3 Certificate of Designation, Preferences and Rights of the Series I Cumulative Preferred Stock of American Realty Investors, Inc., dated February 3, 2003 (incorporated by reference to Exhibit 4.3 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2002).
- 4.4 Certificate of Designation for Nevada Profit Corporations designating the Series J 8% Cumulative Convertible Preferred Stock as filed with the Secretary of State of Nevada on March 16, 2006 (incorporated by reference to Registrant's current report on Form 8-K for event of March 16, 2006).

Edgar Filing: AMERICAN REALTY INVESTORS INC - Form 10-Q

Certificate of Designation for Nevada Profit Corporation designating the Series K Convertible Preferred Stock as filed with the Secretary of State of Nevada on May 6, 2013 (incorporated by reference to Registrant's current report on form 8-K for event of May 7, 2013).

10.1 Advisory Agreement between American Realty Investors, Inc. and Pillar Income Asset Management, Inc., dated April 30, 2011 (incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K, dated May 2, 2011).

10.2 Second Amendment to Modification of Stipulation of Settlement dated October 17, 2001 (incorporated by reference to Exhibit 10.1 to the Registrant's Registration Statement on Form S-4, dated February 24, 2002).

31.1*Certification by the Principal Executive Officer pursuant to Rule 13a-14 and 15d-14 under the Securities Exchange Act of 1934, as amended.

31.2*Certification by the Principal Financial Officer pursuant to Rule 13a-14 and 15d-14 under the Securities Exchange Act of 1934, as amended.

32.1*Certification pursuant to 18 U.S.C. 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

*

Filed herewith

SIGNATURE PAGE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

AMERICAN REALTY INVESTORS, INC.

Date: May 15, 2014

By: /s/ Daniel J. Moos
Daniel J. Moos
President and Chief Executive Officer
(Principal Executive Officer)

Date: May 15, 2014

By: /s/ Gene S. Bertcher
Gene S. Bertcher
Executive Vice President and Chief
Financial Officer
(Principal Financial Officer)

