

TRANSCONTINENTAL REALTY INVESTORS INC
Form 10-K/A
April 07, 2005
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

(Amendment No. 1)

x **ANNUAL REPORT PURSUANT TO SECTIONS 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Year Ended December 31, 2004

.. **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 001-09240

Transcontinental Realty Investors, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Nevada

(State or Other Jurisdiction of Incorporation or Organization)

94-6565852

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

1800 Valley View Lane,

Suite 300, Dallas, Texas

(Address of Principal Executive Offices)

75234

(Zip Code)

(469) 522-4200

(Registrant's Telephone Number, Including Area Code)

Securities Registered Pursuant to Section 12(b) of the Act:

Title of each class
Common Stock, \$.01 par value

Name of each exchange on which registered
New York Stock Exchange

Securities Registered Pursuant to Section 12(g) of the Act:

NONE

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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 at least the past 90 days. Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes No

The aggregate market value of the shares of voting and non-voting common equity held by non-affiliates of the Registrant, computed by reference to the closing sales price of the Common Stock on the New York Stock Exchange as of June 30, 2004 (the last business day of the Registrant's most recently completed second fiscal quarter) was \$21,917,192 based upon a total of 1,622,294 shares held as of June 30, 2004 by persons believed to be non-affiliates of the Registrant. The basis of the calculation does not constitute a determination by the Registrant as defined in Rule 405 of the Securities Act of 1933, as amended, such calculation, if made as of a date within sixty days of this filing would yield a different value. As of March 24, 2005, there were 7,900,869 shares of common stock outstanding.

Documents Incorporated by Reference:

Consolidated Financial Statements of Income Opportunity Realty Investors, Inc.

Commission File No. 001-14784

Consolidated Financial Statements of American Realty Investors, Inc.

Commission File No. 001-15663

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**AMENDMENT #1 FOR ANNUAL REPORT ON 10-K FOR
TRANSCONTINENTAL REALTY INVESTORS, INC.**

The undersigned registrant hereby amends the following items, exhibits, or other portions of its Annual Report on Form 10-K for the fiscal year ended December 31, 2004 as set forth below and as reflected in the substituted pages attached hereto which replace the same numbered pages in the original filing:

Page 18, under Provision for Asset Impairments removed Acres from the table header near the bottom of the page.

Page 31, 3rd paragraph, 1st line, changed translation to transaction.

Under the first table The assets for 2004 include the following properties: removed Acres from table header.

Under the second table The assets for 2003 include the following properties: removed Sq. Feet from table header.

Page 33, Under the first table, The assets for 2003 include the following properties: removed Sq. Feet from table header.

Page 75, Note 20, under Three Months Ended December 31, 2004, changed Earnings Per Share for Net Income/(Loss) from continuing operations to \$.64 instead of (\$2.27) and changed Earnings Per Share for Discontinued operations to \$3.69 instead of \$6.60.

Page 99, Security Ownership of Management, 1st paragraph, 2nd line, changed the date from March 18, 2005 to March 24, 2005.

Page 106, ITEM 15(a) 1, 1st line, Report of Independent Certified Public Accountants changed to Reports of Independent Registered Public Accounting Firms.

Page 115, Certification added to top of document.

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

Transcontinental Realty Investors, Inc.

Dated: April 7, 2005

By: _____ /s/ SCOTT T. LEWIS

Scott T. Lewis

Executive Vice President and

Chief Financial Officer

(Principal Financial and Accounting

Officer and Acting Principal

Executive Officer)

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FORWARD-LOOKING STATEMENTS

Certain Statements in the Form 10-K are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934. The words estimate, plan, intend, expect, anticipate, believe, and similar expressions are intended to identify forward-looking statements. The forward-looking statements are found at various places throughout this Report and in the documents incorporated herein by reference. The Company disclaims any intention or obligations to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Although we believe that our expectations are based upon reasonable assumptions, we can give no assurance that our goals will be achieved. Important factors that could cause our actual results to differ from estimates or projections contained in any forward-looking statements are described under Risk Factors Related to our Business beginning on page 6.

PART I

ITEM 1. BUSINESS

Transcontinental Realty Investors, Inc. (TCI or the Company or we or us), a Nevada corporation, is the successor to a California business trust that was organized on September 6, 1983 and commenced operations on January 31, 1984. On November 30, 1999, TCI acquired all of the outstanding shares of beneficial interest of Continental Mortgage and Equity Trust (CMET), a real estate company, in a tax-free exchange of shares, issuing 1.181 shares of its Common Stock for each outstanding CMET share. Prior to January 1, 2000, TCI elected to be treated as a Real Estate Investment Trust (REIT) under Sections 856 through 860 of the Internal Revenue Code of 1986, as amended (the Code). During the third quarter of 2000, due to a concentration of ownership TCI no longer met the requirement for tax treatment as a REIT. Under the Code, TCI cannot re-qualify for REIT tax status for at least five years after January 1, 2001.

TCI's real estate at December 31, 2004, consisted of 111 properties held for investment, one partnership property, 11 construction properties and 6 properties held for sale. In 2004, TCI purchased 20 properties held for investment. TCI's mortgage notes receivable portfolio at December 31, 2004, consisted of 23 mortgage loans. TCI's real estate and mortgage notes receivable portfolios are more fully discussed in ITEM 2. PROPERTIES.

Effective March 31, 2003, TCI financial results were consolidated in the American Realty Investors, Inc. (ARI) Form 10-K and related consolidated financial statements. As of December 31, 2004, ARI owned 82.2% of the outstanding TCI common shares.

Business Plan and Investment Policy

TCI's business is investing in real estate through direct equity ownership and partnerships and financing real estate and real estate related activities through investments in mortgage loans, including first, wraparound and junior mortgage loans. TCI's real estate is located throughout the continental United States and one property is located in Poland. Information regarding TCI's real estate and mortgage notes receivable portfolios is set forth in ITEM 2. PROPERTIES, and in Schedules III and IV to the Consolidated Financial Statements included in ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA. TCI has four operating segments; apartments, commercial properties, hotels

and land ownership.

TCI's business is not seasonal. Management has determined to continue to pursue a balanced investment policy, seeking both current income and capital appreciation. With respect to new real estate investments, management's plan of operation is to consider all types of real estate with an emphasis on properties generating current cash flow. Management expects to invest in and improve these properties to maximize both their immediate and long-term value. Management has also considered the development of apartment properties in selected markets primarily in Texas. Management also expects to consider property sales opportunities for

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properties in stabilized real estate markets where TCI's properties have reached their potential. Management also expects to be an opportunistic seller of properties in markets that have become overheated, i.e., an abundance of buyers. Management's operating strategy with regard to TCI's properties is to maximize each property's operating income by aggressive property management through closely monitoring expenses while at the same time making property renovations and/or improvements where appropriate. While such expenditures increase the amount of revenue required to cover operating expenses, management believes that such expenditures are necessary to maintain or enhance the value of the properties.

Management does not expect that TCI will seek to fund or acquire new mortgage loans in 2005. However, TCI may originate mortgage loans in conjunction with providing purchase money financing of a property sale. Management intends to service and hold for investment the mortgage notes in TCI's portfolio. TCI may borrow against its mortgage notes, using the proceeds from such borrowings for property acquisitions or for general working capital needs. Management also intends to pursue TCI's rights vigorously with respect to mortgage notes that are in default. TCI's Articles of Incorporation impose no limitations on its investment policy with respect to mortgage loans and does not prohibit it from investing more than a specified percentage of its assets in any one mortgage loan.

Management of the Company

Although the Board of Directors is directly responsible for managing the affairs of TCI and for setting the policies which guide it, its day-to-day operations were performed until July 1, 2003 by Basic Capital Management, Inc. (BCM), a contractual advisor under the supervision of the Board. Effective July 1, 2003, BCM was replaced as contractual advisor to TCI by Prime Asset Management, Inc., (PAMI) under the same terms as BCM's advisory agreement. PAMI is owned by Realty Advisors (80.0%) and Syntek West, Inc. (20.0%), related parties. Syntek West, Inc. is owned by Gene Phillips. Effective August 18, 2003, PAMI changed its name to Prime Income Asset Management, Inc., (PIAMI). On October 1, 2003, Prime Income Asset Management, LLC (Prime), which is owned 100% by PIAMI, replaced PIAMI as the advisor to TCI. The duties of Prime include, among other things, locating, investigating, evaluating and recommending real estate, mortgage note investment and sales opportunities, as well as financing and refinancing sources. Prime also serves as a consultant in connection with TCI's business plan and investment decisions made by the Board.

Prime is indirectly owned by a trust for the children of Gene E. Phillips, and Syntek West, Inc. (which is owned by Mr. Phillips), owns 20% of Prime. Mr. Phillips is not an officer or director of Prime, but serves as a representative of the trust, is involved in daily consultation with the officers of Prime and has significant influence over the conduct of Prime's business, including the rendering of advisory services and the making of investment decisions for itself and for TCI. Prime is more fully described in ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND ADVISOR OF THE REGISTRANT The Advisor.

BCM had provided advisory services to TCI from March 28, 1989 until June 30, 2003, when Prime replaced BCM as the contractual advisor to TCI. Prime also serves as advisor to ARI. The directors of TCI are also directors of ARI. The officers of TCI also serve as officers of ARI, BCM and Prime. As of March 24, 2004, TCI owned approximately 24.0% of IORI's outstanding shares of common stock. ARI owns approximately 82.2% of the outstanding shares of TCI's common stock.

Since February 1, 1990, affiliates of BCM and Prime have provided property management services to TCI. Currently, Triad Realty Services, Ltd. (Triad) provides such property management services. Triad subcontracts with other entities for the provision of property-level management services to TCI. The general partner of Triad is BCM. The limited partner of Triad is Highland Realty Services, Inc. (Highland). Triad subcontracts the property-level management and leasing of 24 of TCI's commercial properties (office buildings, shopping centers and industrial warehouses) to Regis Realty I, LLC (Regis I), which is owned by Highland. Regis I receives property and construction management fees and

leasing commissions in accordance with the terms of its property-level management agreement with Triad. Regis I is also entitled to receive real estate brokerage

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commissions in accordance with the terms of a non-exclusive brokerage agreement. Since January 1, 2003, Regis Hotel I, LLC, has managed TCI's four hotels. The sole member of Regis I and Regis Hotel I, LLC is Highland. See ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND ADVISOR OF THE REGISTRANT The Advisor.

TCI has no employees. Employees of Prime render services to TCI.

Competition

The real estate business is highly competitive and TCI competes with numerous entities engaged in real estate activities (including certain entities described in ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS Related Party Transactions), some of which have greater financial resources than those of TCI. Management believes that success against such competition is dependent upon the geographic location of the property, the performance of property-level managers in areas such as marketing, collections and control of operating expenses, the amount of new construction in the area and the maintenance and appearance of the property. Additional competitive factors with respect to commercial properties are the ease of access to the property, the adequacy of related facilities, such as parking, and sensitivity to market conditions in setting rent levels. With respect to apartments, competition is also based upon the design and mix of units and the ability to provide a community atmosphere for the tenants. Management believes that beyond general economic circumstances and trends, the rate at which properties are renovated or the rate new properties are developed in the vicinity of each of TCI's properties also are competitive factors. See also Risk Factors Related to our Business.

To the extent that TCI seeks to sell any of its properties, the sales prices for such properties may be affected by competition from other real estate entities and financial institutions also attempting to sell their properties located in areas in which TCI's properties are located, as well as by aggressive buyers attempting to penetrate or dominate a particular market.

As described above and in ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS Related Party Transactions, the officers and directors of TCI also serve as officers or directors of certain other entities, also advised by Prime, and which have business objectives similar to those of TCI. TCI's directors, officers and advisor owe fiduciary duties to such other entities as well as to TCI under applicable law. In determining to which entity a particular investment opportunity will be allocated, the officers, directors and advisor consider the respective investment objectives of each such entity and the appropriateness of a particular investment in light of each such entity's existing real estate portfolio. To the extent that any particular investment opportunity is appropriate to more than one of the entities, the investment opportunity will be allocated to the entity which has had funds available for investment for the longest period of time or, if appropriate, the investment may be shared among all or some of the entities.

In addition, as also described in ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS Certain Business Relationships, TCI also competes with other entities which are affiliates of Prime and which have investment objectives similar to TCI's and that may compete with it in purchasing, selling, leasing and financing of real estate and real estate related investments. In resolving any potential conflicts of interest which may arise, Prime has informed management that it intends to continue to exercise its best judgment as to what is fair and reasonable under the circumstances in accordance with applicable law.

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Risk Factors Related to our Business

Adverse events concerning TCI's existing tenants or negative market conditions that may affect TCI's existing tenants could have an adverse impact on TCI's ability to attract new tenants, release space, collect rent or renew leases, and thus could adversely affect cash flow from operations and inhibit growth. Cash flow from operations depends on the ability to lease space to tenants on economically favorable terms. TCI could be adversely affected by various facts and events over which there is limited control, such as:

lack of demand for space in areas where the properties are located;

inability to retain existing tenants and attract new tenants;

oversupply of or reduced demand for space and changes in market rental rates;

defaults by tenants or failure to pay rent on a timely basis;

the need to periodically renovate and repair marketable space;

physical damage to properties;

economic or physical decline of the areas where properties are located;

potential risk of functional obsolescence of properties over time.

At any time, any tenant may experience a downturn in its business that may weaken its financial condition. As a result, a tenant may delay lease commencement, fail to make rental payments when due, decline to extend a lease upon its expiration, become insolvent or declare bankruptcy. Any tenant bankruptcy or insolvency, leasing delay or failure to make rental payments when due could result in the termination of the tenant's lease and material losses to the Company.

If tenants do not renew their leases as they expire, TCI may not be able to rent the space. Furthermore, leases that are renewed, and some new leases for space that is relet, may have terms that are less economically favorable than current lease terms, or may require TCI to incur significant costs, such as for renovations, tenant improvements or lease transaction costs. Any of these events could adversely affect cash flow from operations and TCI's ability to make expected distributions to shareholders and service indebtedness. A significant portion of the costs, such as real estate taxes, insurance costs, and debt service payments, generally are not reduced when circumstances cause a decrease in cash flow from the properties.

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TCI may not be able to compete successfully with other entities that operate in our industry. TCI experiences a great deal of competition in attracting tenants for the properties and in locating land to develop and properties to acquire.

In TCI's effort to lease these properties, TCI competes for tenants with a broad spectrum of other landlords in each of the markets. These competitors include, among others, publicly-held REITs, privately-held entities, individual property owners and tenants who wish to sublease their space. Some of these competitors may be able to offer prospective tenants more attractive financial terms than TCI is able to offer.

If the availability of land or high quality properties in TCI's markets diminishes, operating results could be adversely affected.

TCI may experience increased operating costs, which could adversely affect operations. TCI's properties are subject to increases in operating expenses such as insurance, cleaning, electricity, heating, ventilation and air conditioning, administrative costs and other costs associated with security, landscaping, repairs and maintenance of the properties. While current tenants generally are obligated to pay a significant portion of these costs, there is no assurance that these tenants will make such payments or agree to pay these costs upon renewal or that new tenants will agree to pay these costs. If operating expenses increase in TCI's markets, TCI may not be able to

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increase rents or reimbursements in all of these markets to meet increased expenses, without at the same time decreasing occupancy rates. If this occurs, TCI's ability to make distributions to shareholders and service indebtedness could be adversely affected.

TCI's ability to achieve growth in operating income depends in part on the ability to develop properties which may suffer under certain circumstances. TCI intends to continue to develop properties where warranted by market conditions. The decline in demand for real estate has reduced the amount of development TCI is undertaking. TCI has a number of ongoing development and land projects being readied for development.

Additionally, general construction and development activities includes the following risks:

construction and leasing of a property may not be completed on schedule, which could result in increased expenses and construction costs, and would result in reduced profitability for that property;

construction costs may exceed original estimates due to increases in interest rates and increased materials, labor or other costs, possibly making the property unprofitable because of inability to increase rents to compensate for the increase in construction costs;

some developments may fail to achieve expectations, possibly making them unprofitable;

TCI may be unable to obtain, or face delays in obtaining, required zoning, land-use, building, occupancy, and other governmental permits and authorizations, which could result in increased costs and could require TCI to abandon their activities entirely with respect to a project;

TCI may abandon development opportunities after the initial exploration which may result in failure to recover costs already incurred. If TCI determines to alter or discontinue its development efforts, future costs of the investment may be expensed as incurred rather than capitalized and TCI may determine the investment is impaired resulting in a loss;

TCI may expend funds on and devote management's time to projects which will not be complete;

occupancy rates and rents at newly-completed properties may fluctuate depending on a number of factors, including market and economic conditions, which may result in lower than projected rental rates and the investment is not profitable.

TCI faces risk associated with property acquisitions. TCI acquires individual properties and portfolios of properties, and intends to continue to do so. The acquisition activities and their success are subject to the following risks:

when TCI is able to locate a desired property, competition from other real estate investors may significantly increase the purchase price;

acquired properties may fail to perform as expected;

the actual costs of repositioning or redeveloping acquired properties may be higher than the estimates;

acquired properties may be located in new markets where TCI faces risks associated with an incomplete knowledge or understanding of the local market, a limited number of established business relationships in the area and a relative unfamiliarity with local governmental and permitting procedures;

TCI may be unable to quickly and efficiently integrate new acquisitions, particularly acquisitions of portfolios of properties, into existing operations, and results of operations and financial condition could be adversely affected.

TCI may acquire properties subject to liabilities and without any recourse, or with only limited recourse, with respect to unknown liabilities. As a result, if a liability were asserted against TCI based upon ownership of those properties, TCI might have to pay substantial sums to settle it, which could adversely affect cash flow.

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Many of TCI's properties are concentrated in the Company's primary markets, and, therefore may suffer economic harm as a result of adverse conditions in those markets. TCI's properties are located principally in specific geographic areas in the Southwestern, Southeastern and Midwestern United States. Due to the concentration of properties in these areas, performance is dependent on economic conditions. These areas have experienced periods of economic decline.

TCI is highly leveraged and may not be able to meet our debt service obligations. TCI had total indebtedness at December 31, 2004 of approximately \$644.1 million. Substantially all assets have been pledged to secure debt. These borrowings increase the risk of loss because they represent a prior claim on assets and require fixed payments regardless of profitability. TCI's highly leveraged position makes it vulnerable to changes in economic conditions and may limit the ability to capitalize on significant business opportunities in the future.

TCI may not be able to access financial markets to obtain capital on a timely basis, or on acceptable terms. TCI relies on proceeds from property dispositions and third party capital sources for a portion of its capital needs, including capital for acquisitions and development. The public debt and equity markets are among the sources relied on. There is no guarantee TCI will be able to access these markets, or any other source of capital. The ability to access the public debt and equity markets depends on a variety of factors, including:

general economic conditions affecting these markets;

TCI's own financial structure and performance;

the market's opinion of REITs and real estate companies in general;

the market's opinion of REITs and real estate companies that own properties like TCI.

TCI may suffer adverse effects as a result of the terms of and covenants relating to our indebtedness. Required payments on TCI's indebtedness generally are not reduced if the economic performance of the portfolio declines. If the economic performance declines, net income, cash flow from operations and cash available for distribution to stockholders will be reduced. If payments on debt cannot be made, TCI could sustain a loss, or in the case of mortgages, suffer foreclosures by mortgagees or suffer judgments. Further, some obligations contain cross-default and/or cross-acceleration provisions, which means that a default on one obligation may constitute a default on other obligations.

TCI anticipates only a small portion of the principal of our debt will be repaid prior to maturity. Therefore, TCI is likely to need to refinance at least a portion of its outstanding debt as it matures. There is a risk that TCI may not be able to refinance existing debt or the terms of any refinancing will not be as favorable as the terms of the existing debt. If principal payments due at maturity cannot be refinanced, extended or repaid with proceeds from other sources, such as the proceeds of sales of assets or new equity securities, cash flow will not be sufficient to repay all maturing debt in years when significant balloon payments come due.

TCI's credit facilities and unsecured debt securities contain customary restrictions, requirements and other limitations on the ability to incur indebtedness, including total debt to asset ratios, secured debt to total asset ratios, debt service coverage ratios and minimum ratios of unencumbered assets to unsecured debt which we must maintain. Our continued ability to borrow is subject to compliance with financial and other covenants. In addition, failure to comply with such covenants could cause a default under credit facilities, and TCI may then be required to

repay such debt with capital from other sources. Under those circumstances, other sources of capital may not be available, or be available only on unattractive terms.

TCI's degree of leverage could limit the ability to obtain additional financing or affect the market price of our common stock. The degree of leverage could affect TCI's ability to obtain additional financing for working capital, capital expenditures, acquisitions, development or other general corporate purposes. The degree of leverage could also make TCI more vulnerable to a downturn in business or the economy, in general.

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An increase in interest rates would increase TCI's interest costs on variable rate debt and could adversely impact the ability to refinance existing debt. TCI currently has, and may incur more, indebtedness that bears interest at variable rates. Accordingly, if interest rates increase, so will the interest costs, which would adversely affect cash flow and the ability to pay principal and interest on TCI's debt and the ability to make distributions to shareholders. Further, rising interest rates could limit TCI's ability to refinance existing debt when it matures.

Unbudgeted capital expenditures or cost overruns could adversely affect our business operations and cash flow. If capital expenditures on ongoing or planned development projects, renovations or condominium conversions exceed our expectations, the additional cost of these expenditures could have an adverse effect on business operations and cash flow. In addition, TCI might not have access to funds on a timely basis to meet the unexpected expenditures.

Construction costs are funded in large part through construction financing, which the Company often guarantees, and the Company's obligation to pay interest on this financing continues until the rental project is completed, leased up, and permanent financing is obtained, or the for sale project is sold out. Unexpected delays in completion of one or more ongoing projects could also have a significant adverse impact on business operations and cash flow.

TCI may need to sell properties from time-to time for cash flow purposes. Because of the lack of liquidity of real estate investments generally, TCI's ability to respond to changing circumstances may be impaired. Real estate investments generally cannot be sold quickly. In the event that TCI must sell assets to generate cash flow, TCI cannot predict whether there will be a market for those assets in the time period desired or need to sell them, or whether TCI will be able to sell them at a price that will allow the Company to fully recoup our investment. TCI may not be able to realize the full potential value of the assets, and may incur costs related to the early pay-off of the debt secured by such assets.

TCI intends to devote increasing resources to the development of new projects. TCI plans to continue developing new projects as opportunities arise in the future. Development and construction activities entail a number of risks, including but not limited to the following:

TCI may abandon a project after spending non-recoverable time and money determining its feasibility;

Construction costs may materially exceed original estimates;

The revenue from a new project may not be enough to make it profitable or generate a positive cash flow;

TCI may not be able to obtain financing on favorable terms for development of a property, if at all;

The Company may not complete construction and lease-ups on schedule, resulting in increased development or carrying costs;

TCI may not be able to obtain, or may be delayed in obtaining, necessary governmental permits.

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TCI's overall business is subject to all of the risks associated with the real estate industry. TCI is subject to all risks incident to investment in real estate, many of which relate to the general lack of liquidity of real estate investments, including, but not limited to:

changes in general or local economic conditions because TCI's real estate assets are concentrated in the Southwest, any deterioration in the general economic conditions in any of those states could have an adverse effect on business and assets in that state;

changes in interest rates may make the ability to satisfy debt service requirements materially more burdensome;

lack of availability of financing may render the purchase, sale or refinancing of a property more difficult or unattractive;

changes in real estate and zoning laws;

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increases in real estate taxes and insurance costs;

federal or local economic or rent control, and

floods, earthquakes and other similar natural disasters.

Available Information

TCI maintains an internet site at <http://www.transconrealty-invest.com>. TCI has available through their website free of charge Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, reports filed pursuant to Section 16 and amendments to those reports as soon as reasonably practicable after we electronically file or furnish such materials to the Securities and Exchange Commission. In addition, the Company has posted the charters for our Audit Committee, Compensation Committee and Governance and Nominating Committee, as well as our Code of Business Conduct and Ethics, Corporate Governance Guidelines on Director Independence and other information on the website. These charters and principles are not incorporated in this Report by reference. TCI will also provide a copy of these documents free of charge to stockholders upon written request. The Company issues Annual Reports containing audited financial statements to its common stockholders.

ITEM 2. PROPERTIES

TCI's principal offices are located at 1800 Valley View Lane, Suite 300, Dallas, Texas 75234 and are, in the opinion of management, suitable and adequate for TCI's present operations.

Details of TCI's real estate and mortgage notes receivable portfolios at December 31, 2004, are set forth in Schedules III and IV to the Consolidated Financial Statements included at ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA. The discussions set forth below under the headings Real Estate and Mortgage Loans provide certain summary information concerning TCI's real estate and mortgage notes receivable portfolios.

TCI's real estate portfolio consists of properties held for investment, properties held for sale, properties subject to sales contract, and investments in partnerships. The discussion set forth below under the heading Real Estate provides certain summary information concerning TCI's real estate and further summary information with respect to its properties held for investment, properties held for sale and its investment in partnerships.

At December 31, 2004, none of TCI's properties, mortgage notes receivable or investments in partnerships exceeded 10.0% of total assets. At December 31, 2004, 71.5% of TCI's assets consisted of properties held for investment, 5.4% consisted of properties held for sale, 7.6% consisted of properties subject to sales contract, 6.2% consisted of mortgage notes and interest receivables and 1.9% consisted of investments in partnerships and equity investees. The remaining 7.4% of TCI's assets were invested in cash, cash equivalents and other assets. The percentage of TCI's assets invested in any one category is subject to change and no assurance can be given that the composition of TCI's assets in the future will approximate the percentages listed above.

TCI's real estate is geographically diverse. At December 31, 2004, TCI held investments in apartments and commercial properties in each of the geographic regions of the continental United States, although its apartments and commercial properties were concentrated in the Southeast and Southwest regions, as shown more specifically in the table under "Real Estate" below. At December 31, 2004, TCI held mortgage notes receivable secured by apartments and commercial properties in the Southwest and Southeast regions of the continental United States, as shown more specifically in the table under "Mortgage Loans" below.

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Geographic Regions

TCI has divided the continental United States into the following geographic regions.

Excluded from the above is one hotel in Wroclaw, Poland and a partnership property, as described below.

Real Estate

At December 31, 2004, approximately 84.5% of TCI's assets were invested in real estate. TCI invests primarily in real estate located throughout the continental United States, either on a leveraged or non-leveraged basis. TCI's real estate portfolio consists of properties held for investment, investments in partnerships and properties held for sale.

Types of Real Estate Investments. TCI's real estate consists of commercial properties (office buildings, industrial warehouses and shopping centers), hotels and apartments having established income-producing capabilities. In selecting real estate for investment, the location, age and type of property, gross rents, lease terms, financial and business standing of tenants, operating expenses, fixed charges, land values and physical condition are among the factors considered. TCI may acquire properties subject to or assume existing debt and may mortgage, pledge or otherwise obtain financing for its properties. The Board of Directors may alter the types of criteria for selecting new real estate investments and for obtaining financing without a vote of stockholders.

TCI's current real estate portfolio consists of 129 owned properties. Of the 129 properties, 12 apartments were sold to partnerships controlled by Metra Capital, LLC (Metra). See NOTE 8. RELATED PARTY TRANSACTIONS. Because the Metra sales transaction was accounted for as a finance transaction, TCI continues to account for the 12 properties as owned properties.

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TCI typically invests in developed real estate. However, TCI has recently invested in unimproved land and apartment development and construction. To the extent that TCI continues to invest in development and construction projects, it will be subject to business risks, such as cost overruns and construction delays, associated with higher risk projects.

At December 31, 2004, TCI had the following properties under construction:

| <u>Property</u> | <u>Location</u> | <u>Units</u> | <u>Amount Expended</u> | <u>Additional Amount to Expend</u> | <u>Construction Loan Funding</u> |
|--|--------------------|--------------|----------------------------|--|--|
| <i>Apartments</i> | | | | | |
| Blue Lake Villas II | Waxahachie, TX | 76 Units | \$ 4,454 | \$ 217 | \$ 4,234 |
| Bluffs at Vista Ridge | Lewisville, TX | 272 Units | 17,239 | 3,347 | 15,500 |
| Bridges on Kinsey | Tyler, TX | 232 Units | 11,572 | 4,509 | 14,477 |
| Dakota Arms | Lubbock, TX | 208 Units | 12,611 | 1,326 | 12,549 |
| Kingsland Ranch | Houston, TX | 398 Units | 24,573 | 1,081 | 23,000 |
| Laguna Vista | Farmers Branch, TX | 206 Units | 3,432 | 17,673 | 17,741 |
| Lake Forest | Houston, TX | 240 Units | 13,919 | 519 | 12,815 |
| Parc at Maumelle | Maumelle, AR | 240 Units | 4,502 | 14,196 | 16,829 |
| Stonebridge at City Park (formerly 288 City Park) | Houston, TX | 240 Units | 15,486 | 1,201 | 15,005 |
| Vistas of Vance Jackson | San Antonio, TX | 240 Units | 13,393 | 4,708 | 16,056 |
| Wildflower Villas | Temple, TX | 220 Units | 9,377 | 6,220 | 14,073 |

For the period ending December 31, 2004, TCI completed the 248 unit DeSoto Ranch Apartments in DeSoto, Texas, the 314 unit Verandas at Cityview Apartments in Fort Worth, Texas, the 216 unit Mariposa Villas (Echo Valley) in Dallas, Texas, the 176 unit Breakwater Bay Apartments in Beaumont, Texas, the 156 unit Capitol Hill Apartments in Little Rock, Arkansas and the 332 unit Vistas of Pinnacle Park Apartments in Dallas, Texas.

In 2003, TCI completed 186 unit Blue Lake Villas in Waxahachie, Texas, the 284 unit Falcon Lakes in Arlington, Texas, the 180 unit River Oaks Apartments in Wiley, Texas, the 384 unit Sendero Ridge Apartments in San Antonio, Texas, the 256 unit Spyglass Apartments in Mansfield, Texas and the 188 unit Windsong Apartments in Fort Worth, Texas.

In the opinion of management, the properties owned by TCI are adequately covered by insurance.

The following table sets forth the percentages, by property type and geographic region, of TCI's real estate (other than four hotels in the Pacific and Midwest regions, one hotel in Poland and 38 parcels of unimproved land, as described below) at December 31, 2004.

RegionApartmentsCommercial
Properties

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| | | |
|-----------|----------------|----------------|
| Pacific | % | 1.33% |
| Midwest | .61 | 14.54 |
| Mountain | | 6.25 |
| Southwest | 98.15 | 63.88 |
| Southeast | 1.24 | 14.00 |
| | <u>100.00%</u> | <u>100.00%</u> |

The foregoing table is based solely on the number of apartment units and amount of commercial square footage and does not reflect the value of TCI's investment in each region. TCI owns 38 parcels of unimproved land, two parcels for a total of 21.23 acres in the Southeast region and 36 parcels for a total of 969.30 acres in the Southwest region. See Schedule III to the Consolidated Financial Statements included at ITEM 8.

FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA for a detailed description of TCI's real estate portfolio.

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During 2004, the activity in TCI's owned real estate portfolio was:

| | |
|--|-------|
| Owned properties at January 1, 2004 | 134 |
| Properties purchased (excluding additions to existing land parcels or land for construction) | 20 |
| Properties added from consolidation of partnerships | 1 |
| Properties sold (excluding partial sales) | (26) |
| | <hr/> |
| Owned properties at December 31, 2004 | 129 |
| | <hr/> |

Properties Held for Investment. Set forth below are TCI's properties held for investment and the monthly rental rate for apartments, the average annual rental rate for commercial properties and the average daily room rate and room revenue divided by total available rooms for hotels and occupancy at December 31, 2004, 2003 and 2002, for apartments and commercial properties and average occupancy during 2004, 2003 and 2002 for hotels:

| Property | Location | Units/Square Footage | Rent Per | | | Occupancy % | | |
|------------------------|--------------------|---------------------------|-------------|--------|--------|-------------|------|------|
| | | | Square Foot | | | Occupancy % | | |
| | | | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 |
| Apartments | | | | | | | | |
| 4400 | Midland, TX | 92 Units/94,472 Sq. Ft. | \$.51 | \$.49 | \$.49 | 97 | 86 | 86 |
| Apple Lane | Lawrence, KS | 75 Units/30,000 Sq. Ft. | 1.08 | 1.05 | 1.04 | 100 | 100 | 93 |
| Arbor Point | Odessa, TX | 195 Units/178,920 Sq. Ft. | .47 | .45 | .43 | 90 | 95 | 87 |
| Ashton Way | Midland, TX | 178 Units/138,964 Sq. Ft. | .45 | .43 | .43 | 95 | 87 | 82 |
| Autumn Chase | Midland, TX | 64 Units/58,652 Sq. Ft. | .57 | .55 | .54 | 98 | 98 | 98 |
| Blue Lake Villas | Waxahachie, TX | 186 Units/169,746 Sq. Ft. | .91 | .91 | ** | 90 | 92 | ** |
| Breakwater Bay | Beaumont, TX | 176 Units/145,688 Sq. Ft. | .93 | ** | ** | 87 | ** | ** |
| By the Sea | Corpus Christi, TX | 153 Units/123,945 Sq. Ft. | .88 | .88 | .86 | 96 | 91 | 88 |
| Capitol Hill | Little Rock, AR | 156 Units/151,116 Sq. Ft. | .88 | ** | ** | 70 | ** | ** |
| Courtyard | Midland, TX | 133 Units/111,576 Sq. Ft. | .47 | .46 | .45 | 94 | 99 | 93 |
| Coventry | Midland, TX | 120 Units/105,608 Sq. Ft. | .45 | .44 | .43 | 96 | 84 | 91 |
| DeSoto Ranch | DeSoto, TX | 248 Units/240,718 Sq. Ft. | .95 | .94 | ** | 98 | 98 | ** |
| El Chapparal | San Antonio, TX | 190 Units/174,220 Sq. Ft. | .75 | .73 | .72 | 94 | 96 | 79 |
| Fairway View Estates | El Paso, TX | 264 Units/204,000 Sq. Ft. | .65 | .64 | .63 | 90 | 96 | 92 |
| Fairways | Longview, TX | 152 Units/134,176 Sq. Ft. | .59 | .58 | .56 | 96 | 93 | 92 |
| Falcon Lakes | Arlington, TX | 284 Units/207,960 Sq. Ft. | .96 | .96 | .97 | 94 | 94 | 11 |
| Fountain Lake | Texas City, TX | 166 Units/161,220 Sq. Ft. | .62 | .62 | .62 | 86 | 96 | 89 |
| Fountains of Waterford | Midland, TX | 172 Units/129,200 Sq. Ft. | .55 | .53 | .53 | 96 | 99 | 85 |
| Harper's Ferry | Lafayette, LA | 122 Units/112,500 Sq. Ft. | .61 | .60 | .59 | 95 | 90 | 83 |
| Heather Creek | Mesquite, TX | 200 Units/170,212 Sq. Ft. | .94 | ** | ** | 93 | ** | ** |
| Hunters Glen | Midland, TX | 212 Units/174,180 Sq. Ft. | .42 | .39 | .38 | 93 | 94 | 81 |
| Limestone Canyon | Austin, TX | 260 Units/216,000 Sq. Ft. | 1.06 | 1.06 | 1.06 | 96 | 91 | 88 |
| Limestone Ranch | Lewisville, TX | 252 Units/219,600 Sq. Ft. | .95 | .94 | .94 | 95 | 91 | 91 |
| Mariposa Villas | Dallas, TX | 216 Units/200,928 Sq. Ft. | .89 | .89 | ** | 95 | 97 | ** |
| Mountain Plaza | El Paso, TX | 188 Units/220,710 Sq. Ft. | .52 | .52 | .51 | 90 | 94 | 97 |
| Oak Park IV | Clute, TX | 108 Units/78,708 Sq. Ft. | .56 | .56 | .56 | 93 | 91 | 95 |
| Paramount Terrace | Amarillo, TX | 181 Units/123,840 Sq. Ft. | .61 | .60 | .59 | 91 | 93 | 91 |
| Plantation | Tulsa, OK | 138 Units/103,500 Sq. Ft. | .61 | .61 | .61 | 90 | 92 | 90 |
| Quail Oaks | Balch Springs, TX | 131 Units/72,848 Sq. Ft. | .83 | .83 | .83 | 95 | 95 | 85 |
| River Oaks | Wiley, TX | 180 Units/164,604 Sq. Ft. | .86 | .86 | ** | 95 | 98 | ** |

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| | | | | | | | | |
|-------------------------|-----------------|----------------------------|------|------|-----|----|-----|----|
| Sendero Ridge | San Antonio, TX | 384 Units/340,880 Sq. Ft. | 1.02 | 1.01 | ** | 94 | 80 | ** |
| Somerset | Texas City, TX | 200 Units/163,368 Sq. Ft. | .68 | .68 | .68 | 85 | 88 | 87 |
| Southgate | Odessa, TX | 180 Units/151,656 Sq. Ft. | .46 | .43 | .43 | 98 | 93 | 90 |
| Spy Glass | Mansfield, TX | 256 Units/ 239,264 Sq. Ft. | .96 | .95 | ** | 92 | 97 | ** |
| Sunchase | Odessa, TX | 300 Units/223,048 Sq. Ft. | .51 | .49 | .49 | 97 | 96 | 91 |
| Terrace Hills | El Paso, TX | 310 Units/233,192 Sq. Ft. | .70 | .70 | .69 | 94 | 96 | 93 |
| Tivoli | Dallas, TX | 190 Units/168,862 Sq. Ft. | .95 | .95 | .96 | 92 | 92 | 27 |
| Timbers | Tyler, TX | 180 Units/101,666 Sq. Ft. | .60 | .60 | .59 | 96 | 92 | 93 |
| Treehouse | Irving, TX | 160 Units/153,072 Sq. Ft. | .80 | *** | .80 | 96 | *** | 94 |
| Verandas at City View | Fort Worth, TX | 314 Units/295,170 Sq. Ft. | .92 | .60 | ** | 93 | 92 | ** |
| Vistas at Pinnacle Park | Dallas, TX | 332 Units/276,928 Sq. Ft. | .91 | ** | ** | 96 | ** | ** |
| Westwood | Odessa, TX | 79 Units/49,001 Sq. Ft. | .46 | .44 | .49 | 91 | 100 | 80 |
| Willow Creek | El Paso, TX | 112 Units/103,140 Sq. Ft. | .58 | .57 | .55 | 97 | 96 | 94 |
| Willo-Wick Gardens | Pensacola, FL | 152 Units/153,360 Sq. Ft. | .55 | .55 | .54 | 95 | 91 | 84 |
| Windsong | Fort Worth, TX | 188 Units/169,464 Sq. Ft. | .89 | ** | ** | 91 | ** | ** |
| Woodview | Odessa, TX | 232 Units/165,840 Sq. Ft. | .53 | .52 | .51 | 93 | 94 | 85 |

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| Property | Location | Units/Square Footage | Rent Per | | | Occupancy % | | |
|------------------------------|----------------------|----------------------|-------------|-------|-------|-------------|------|------|
| | | | Square Foot | | | | | |
| | | | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 |
| Office Buildings | | | | | | | | |
| 1010 Common | New Orleans, LA | 494,579 Sq. Ft. | 14.08 | 13.63 | 12.77 | 84 | 82 | 74 |
| 225 Baronne | New Orleans, LA | 416,834 Sq. Ft. | 10.70 | 10.63 | 9.89 | 69 | 65 | 76 |
| Amoco | New Orleans, LA | 378,244 Sq. Ft. | 13.66 | 13.37 | 12.73 | 69 | 78 | 79 |
| Bay Plaza | Tampa, FL | 75,780 Sq. Ft. | 13.96 | 14.98 | 15.85 | 54 | 80 | 86 |
| Bay Plaza II | Tampa, FL | 78,882 Sq. Ft. | 12.79 | 13.23 | 13.01 | 77 | 78 | 72 |
| Eton Square | Tulsa, OK | 222,654 Sq. Ft. | 11.09 | 11.60 | 11.35 | 75 | 38 | 42 |
| Executive Court | Memphis, TN | 41,840 Sq. Ft. | * | * | * | * | * | * |
| Forum | Richmond, VA | 79,791 Sq. Ft. | 13.68 | 14.23 | 15.32 | 76 | 61 | 60 |
| Lexington Center | Colorado Springs, CO | 74,603 Sq. Ft. | 10.56 | 12.33 | 13.41 | 58 | 70 | 84 |
| Parkway North | Dallas, TX | 71,041 Sq. Ft. | 16.58 | 18.08 | 17.41 | 60 | 64 | 72 |
| Signature | Dallas, TX | 56,532 Sq. Ft. | 10.00 | **** | **** | 100 | **** | **** |
| Westgrove Air Plaza | Addison, TX | 78,326 Sq. Ft. | 12.68 | 13.26 | 13.96 | 74 | 94 | 66 |
| Industrial Warehouses | | | | | | | | |
| 5360 Tulane | Atlanta, GA | 30,000 Sq. Ft. | 2.85 | 2.80 | 2.75 | 100 | 65 | 100 |
| Addison Hanger | Addison, TX | 23,650 Sq. Ft. | 7.54 | 7.94 | 8.12 | 67 | 100 | 98 |
| Addison Hanger II | Addison, TX | 29,000 Sq. Ft. | 9.24 | 9.64 | 9.33 | 92 | 92 | 97 |
| Encon | Fort Worth, TX | 256,410 Sq. Ft. | 3.12 | 3.17 | 3.17 | 100 | 100 | 100 |
| Space Center | San Antonio, TX | 101,500 Sq. Ft. | 3.41 | 3.43 | 3.46 | 61 | 84 | 84 |
| Shopping Centers | | | | | | | | |
| Bridgeview Plaza | LaCrosse, WI | 116,008 Sq. Ft. | 6.97 | 7.25 | * | 89 | 90 | * |
| Cullman | Cullman, AL | 92,466 Sq. Ft. | 3.55 | 3.53 | * | 27 | 95 | * |
| Dunes Plaza | Michigan City, IN | 223,869 Sq. Ft. | 5.91 | 5.51 | 5.83 | 64 | 61 | 69 |
| Promenade | Highland Ranch, CO | 133,558 Sq. Ft. | 10.45 | 10.94 | 12.41 | 85 | 79 | 81 |

Total Room Revenues

Divided By

| Property | Location | Rooms | Average Room Rate | | | Occupancy % | | | Total Available Rooms | | |
|--------------|-------------------|-----------|-------------------|-----------|-----------|-------------|------|------|-----------------------|----------|----------|
| | | | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 |
| | | | Hotels | | | | | | | | |
| Willows | Chicago, IL | 52 Rooms | \$ 119.84 | \$ 121.24 | \$ 129.76 | 57 | 53 | 49 | 67.62 | \$ 69.54 | \$ 63.35 |
| City Suites | Chicago, IL | 45 Rooms | 126.29 | 120.16 | 131.46 | 58 | 58 | 56 | 71.60 | 76.78 | 73.38 |
| Majestic Inn | San Francisco, CA | 57 Rooms | 129.43 | 107.67 | 141.62 | 50 | 52 | 37 | 64.10 | 66.68 | 52.25 |
| The Majestic | Chicago, IL | 55 Rooms | 129.64 | 124.47 | 133.79 | 52 | 48 | 52 | 65.91 | 57.86 | 64.31 |
| Akademia | Wroclaw, Poland | 161 Rooms | 55.33 | 47.78 | 48.92 | 65 | 51 | 33 | 35.98 | 46.86 | 15.97 |

| Property | Location | Acres |
|--------------------|--------------------|--------------|
| Land | | |
| 1013 Common | New Orleans, LA | .413 Acres |
| 2301 Valley Branch | Farmers Branch, TX | 23.763 Acres |
| Alamo Springs | Dallas, TX | .678 Acres |
| Centura | Farmers Branch, TX | 8.753 Acres |
| Cooks Lane | Fort Worth, TX | 23.242 Acres |

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| | | |
|---------------------|--------------------|--------------|
| Denton-Coonrod | Denton, TX | 82.203 Acres |
| DeSoto | DeSoto, TX | 21.897 Acres |
| Dominion | Farmers Branch, TX | 14.39 Acres |
| Fiesta | San Angelo, TX | .6657 Acres |
| Fruitland | Fruitland Park, FL | 4.66 Acres |
| Folsom | Farmers Branch, TX | 36.777 Acres |
| Granbury Station | Fort Worth, TX | 15.696 Acres |
| Hollywood Casino | Farmers Branch, TX | 42.815 Acres |
| Lacy Longhorn | Farmers Branch, TX | 17.115 Acres |
| Lakeshore Villas | Humble, TX | 1.36 Acres |
| Lamar/Palmer | Austin, TX | 17.07 Acres |
| Las Colinas | Las Colinas, TX | 4.7 Acres |
| LCLLP | Las Colinas, TX | 45.49 Acres |
| Lemmon Carlisle | Dallas, TX | 2.14 Acres |
| Limestone Canyon II | Austin, TX | 9.96 Acres |
| Lubbock | Lubbock, TX | 2.866 Acres |

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| Property | Location | Acres |
|--|--------------------|---------------|
| Manhattan | Farmers Branch, TX | 108.892 Acres |
| Marine Creek | Ft. Worth, TX | 43.43 Acres |
| Mason Park | Houston, TX | 18 Acres |
| McKinney 36 | Collin County, TX | 34.58 Acres |
| Mira Lago | Farmers Branch, TX | 4.152 Acres |
| Nashville | Nashville, TN | 16.57 Acres |
| Pac Trust | Farmers Branch, TX | 7.07 Acres |
| Payne (TCI owns a 50% Tenant-In-Common interest) | Las Colinas, TX | 268.0 Acres |
| Pulaski | Pulaski County, AR | 21.9 Acres |
| Railroad | Dallas, TX | .293 Acres |
| Rochelle I | Las Colinas, TX | 10.096 Acres |
| Rochelle II | Las Colinas, TX | 21.269 Acres |
| Rogers | Rogers, AR | 20.08 Acres |
| Round Mountain | Austin, TX | 18 Acres |
| Seminary West | Ft. Worth, TX | 5.36 Acres |
| Sheffield Village | Grand Prairie, TX | 13.9 Acres |
| Valley Ranch | Irving, TX | 29.9 Acres |
| West End | Dallas, TX | 6.96 Acres |

* Property was purchased in 2002, 2003 or 2004.

** Property was under construction.

*** Property was sold in 2003 and purchased in 2004.

**** No applicable data for Signature Athletic Club. TCI sold the athletic club in November 2004 but retained the Signature office building.

Occupancy presented here and throughout this ITEM 2. is without reference to whether leases in effect are at, below or above market rates.

NOTE 2. REAL ESTATE

In 2004, TCI purchased the following properties:

| Property | Location | Units/ Sq. Ft./Acres | Purchase Price | Net | | | Maturity Date |
|--|--------------------|---------------------------------|---------------------------|--------------------------------------|--------------------------|--------------------------|--------------------------|
| | | | | Cash Paid/ (Received) | Debt Incurred | Interest Rate | |
| Apartments | | | | | | | |
| 288 City Park ⁽¹⁾ | Houston, TX | 240 Units | \$ 3,056 | \$ 612 | \$ 2,444 | 5.95% | 04/45 |
| Blue Lake Villas II ⁽¹⁾ | Waxahachie, TX | 70 Units | 729 | (164) | 729 | 5.80 | 04/45 |
| Bridges on Kinsey ⁽¹⁾ | Tyler, TX | 232 Units | 2,291 | 596 | 1,687 | 5.74 | 08/45 |
| Dakota Arms ⁽¹⁾ | Lubbock, TX | 208 Units | 2,472 | 681 | 1,791 | 5.85 | 06/45 |
| Laguna Vista ⁽¹⁾ | Farmers Branch, TX | 206 Units | 2,424 | 902 | 1,522 | 5.50 | 09/46 |
| Lake Forest ⁽¹⁾ | Houston, TX | 240 Units | 2,316 | (470) | 2,316 | 5.60 | 03/45 |
| Parc at Maumelle ⁽¹⁾ | Maumelle, AR | 240 Units | 3,120 | 916 | 2,204 | 5.37 | 07/46 |
| Treehouse ⁽²⁾ | Irving, TX | 160 Units | 7,519 | (498) | 5,027 ⁽³⁾ | 5.00 | 08/13 |
| Vistas of Vance Jackson ⁽¹⁾ | San Antonio, TX | 240 Units | 3,550 | 771 | 2,779 | 5.78 | 06/45 |
| Wildflower Villas ⁽¹⁾ | Temple, TX | 220 Units | 2,045 | 79 | 1,966 | 5.99 | 10/45 |

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Commercial

| | | | | | | | | |
|--------------------------------|-------------|----------------|-------|--|--|--|--|--|
| Executive Court ⁽⁴⁾ | Memphis, TN | 41,840 Sq. Ft. | 1,970 | | | | | |
|--------------------------------|-------------|----------------|-------|--|--|--|--|--|

Land

| | | | | | | | | |
|-----------------------------------|--------------------|--------------|--------|-------|-----------------------|-------|-------|--|
| Cooks Lane land | Ft. Worth, TX | 23.242 Acres | 1,000 | 1,034 | | | | |
| Denton-Coonrod land | Denton, TX | 82.203 Acres | 1,644 | 1,046 | 840 | 6.25 | 11/06 | |
| DeSoto land | DeSoto, TX | 21.897 Acres | 2,516 | 1,364 | 1,265 | 6.25 | 11/06 | |
| Granbury Station land | Ft. Worth, TX | 15.696 Acres | 923 | 236 | 738 | 7.00 | 09/07 | |
| Lacy Longhorn land ⁽⁵⁾ | Farmers Branch, TX | 17.115 Acres | 4,474 | | | | | |
| Las Colinas land ⁽⁶⁾ | Las Colinas, TX | 239.2 Acres | 39,145 | | 10,006 ⁽⁷⁾ | (7) | (7) | |
| Lubbock land | Lubbock, TX | 2.866 Acres | 224 | 224 | | | | |
| Railroad land | Dallas, TX | .293 Acres | 708 | 704 | | | | |
| Rogers land | Rogers, AR | 20.08 Acres | 1,390 | 619 | 1,130 | 10.50 | 04/05 | |
| Vista Ridge land ⁽⁸⁾ | Lewisville, TX | 14.216 Acres | 2,585 | | | | | |
| West End land ⁽⁹⁾ | Dallas, TX | .158 Acres | 71 | 71 | | | | |

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- (1) Initial construction loan funding to purchase land and begin apartment construction, does not represent actual units purchased.
- (2) Purchased from IORI, a related party, for assumption of debt and a note receivable, less \$498,000 in cash received.
- (3) Assumed debt.
- (4) Property received from ARI, a related party, for payment of a note receivable. See NOTE 3. NOTES AND INTEREST RECEIVABLE.
- (5) Property received from ARI, a related party, for a decrease of \$4.5 million to TCI's affiliate receivable with Prime.
- (6) The following tracts of land were purchased from ARI, a related party, for a decrease of \$29.1 million to TCI's affiliate receivable from Prime: Payne, LCLLP, Rochelle I & II and Valley Ranch. TCI owns a 50% Tenant-in-Common interest in the 268 acre Payne tract.
- (7) Includes \$3.1 million assumed debt on the LCLLP tract with an interest rate of 7.0% and a maturity date of 12/06 and \$6.9 million assumed debt on the Rochelle I & II and Valley Ranch tracts with an interest rate of prime plus 3% (currently 8.75%) and a maturity date of 11/05.
- (8) Property received from ARI, a related party, for a decrease of \$2.6 million to TCI's affiliate receivable from Prime.
- (9) TCI purchased a 50% interest in this land tract.

In 2004, TCI sold the following properties:

| Property | Location | Units/ Sq. Ft./Acres | Sales Price | Net | | Gain/(Loss) on Sale |
|---|--------------------|-------------------------|----------------|----------------------|--------------------------|------------------------|
| | | | | Cash Received | Debt Discharged | |
| Apartments | | | | | | |
| Cliffs of El Dorado ⁽²⁾ | McKinney, TX | 208 Units | \$ 13,442 | \$ 10 | \$ 10,323 ⁽¹⁾ | \$ ⁽³⁾ |
| In The Pines | Gainesville, FL | 242 Units | 11,300 | 3,547 ⁽⁴⁾ | 5,201 | 5,136 |
| Sandstone | Mesa, AZ | 238 Units | 8,650 | 2,687 | 5,531 | 1,136 |
| Waters Edge IV ⁽⁵⁾ | Gulfport, MS | 80 Units | 5,000 | | | ⁽⁶⁾ |
| Office Building | | | | | | |
| 4135 Beltline | Addison, TX | 90,000 Sq. Ft. | 4,900 | 2,472 | 2,009 | 345 |
| Atrium | Palm Beach, FL | 74,603 Sq. Ft. | 5,775 | 1,667 | 3,772 | 328 |
| Ambulatory Surgery Center | Sterling, VA | 33,832 Sq. Ft. | 8,675 | 5,448 | 2,856 | 202 |
| Brandeis ⁽⁷⁾ | Omaha, NE | 319,234 Sq. Ft. | | | 8,750 ⁽¹⁾ | ⁽⁹²⁾ |
| Centura Tower ⁽⁸⁾ | Farmers Branch, TX | 410,901 Sq. Ft. | 84,075 | 36,350 | 49,878 | 31,550 |
| Corporate Pointe | Chantilly, VA | 65,918 Sq. Ft. | 9,000 | 5,025 | 3,609 | 5,239 |
| Countryside Harmon | Sterling, VA | 72,062 Sq. Ft. | 9,150 | 4,608 | 3,865 | 1,931 |
| Countryside Retail | Sterling, VA | 133,422 Sq. Ft. | 27,100 | 3,408 | 22,800 | 6,236 |
| Countryside Mimado | Sterling, VA | 35,127 Sq. Ft. | 4,000 | 102 | 941 | 72 |
| Durham Centre ⁽⁹⁾ | Durham, NC | 207,171 Sq. Ft. | 21,300 | 6,703 | | ⁽¹⁰⁾ |
| One Steeplechase | Sterling, VA | 103,376 Sq. Ft. | 11,900 | 3,743 | 7,654 | 6,184 |
| Venture Center | Atlanta, GA | 38,272 Sq. Ft. | 4,000 | 997 | 2,550 | 1,167 |
| Industrial Warehouse | | | | | | |
| Kelly (Cash Road) | Dallas, TX | 97,150 Sq. Ft. | 1,500 | 1,077 | 422 | 127 |
| Kelly (Pinewood) | Dallas, TX | 100,000 Sq. Ft. | 1,650 | 65 | 1,376 | 153 |
| Ogden Industrial | Ogden, UT | 107,112 Sq. Ft. | 2,600 | 668 | 1,775 | 1,374 |
| Texstar Warehouse ⁽¹²⁾ | Arlington, TX | 97,846 Sq. Ft. | 2,400 | | 1,148 ⁽¹⁾⁽¹⁷⁾ | ⁽¹³⁾ |
| Other | | | | | | |
| Signature Athletic Club ⁽¹¹⁾ | Dallas, TX | N/A | 120 | (154) | 88 | ⁽⁴⁷⁾ |
| Shopping Center | | | | | | |
| K-Mart ⁽¹²⁾ | Cary, NC | 92,033 Sq. Ft. | 3,200 | | 1,677 ⁽¹⁾⁽¹⁷⁾ | ⁽¹⁴⁾ |
| Sadler Square | Amelia Island, FL | 70,295 Sq. Ft. | 4,500 | 1,876 | 2,680 | 1,673 |
| Land | | | | | | |
| Allen | Collin County, TX | 492.531 Acres | 19,962 | 7,956 | 4,088 | 7,056 |
| Marine Creek ⁽¹⁵⁾ | Ft. Worth, TX | 10.73 Acres | 1,488 | 1,198 | 991 | ⁽¹⁶⁾ |
| Rasor | Plano, TX | 24.5 Acres | 2,600 | 2,600 | 1,260 | 53 |
| Red Cross | Dallas, TX | 2.89 Acres | 8,500 | 2,842 | 4,450 | |

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- (1) Assumed debt.
- (2) Property initially sold to Unified Housing Foundation, Inc. (UHF), a related party, in 2003. See NOTE 8. RELATED PARTY TRANSACTIONS.
- (3) Excludes a \$1.7 million deferred gain from a related party sale.
- (4) TCI provided \$1.0 million of the purchase price as seller financing. See NOTE 3. NOTES AND INTEREST RECEIVABLE.
- (5) Property sold to ARI, a related party, for an increase of \$5.0 million to the affiliate receivable balance from Prime.
- (6) Excludes a \$494,000 deferred gain from a related party sale.
- (7) Brandeis was returned to lender via a deed in lieu of foreclosure process. See NOTE 7. NOTES AND INTEREST PAYABLE.
- (8) TCI sold a 95% limited partnership interest, retaining a 1% general partner and 4% limited partner interest.
- (9) Property sold to Edina Park Plaza Associates, L.P., of which the managing general partner is a subsidiary of ARI, a related party, for a wraparound note of \$14.5 million and cash.
- (10) Excludes a \$4.0 million deferred gain from a related party sale.
- (11) Signature Athletic Club was sold for the assumption of capital leases by purchaser. Net cash paid is from prepaid dues and unearned revenues due purchaser.
- (12) Property sold to Basic Capital Management (BCM), a related party, for assumption of debt and a note receivable. See NOTE 3. NOTES AND INTEREST RECEIVABLE.
- (13) Excludes a \$1.0 million deferred gain from a related party sale.
- (14) Excludes \$355,000 deferred gain from a related party sale.
- (15) Property sold to UHF, a related party, for cash and a note receivable. See NOTE 8. RELATED PARTY TRANSACTIONS
- (16) Excludes a \$581,000 deferred gain from a related party sale.
- (17) Failure to notify and receive approval from the lender for this transaction may constitute an event of default under the terms of the debt.

In 2004, TCI financed/refinanced the following properties:

| Property | Location | Sq. Ft./ | | Net Cash | | | Maturity Date |
|--|--------------------|-----------------------|-----------------------|--------------------|---------------------|---------------------|----------------------|
| | | Units/Rooms/ Acres | Debt Incurred | Debt Discharged | Received/ (Paid) | Interest Rate | |
| Apartments | | | | | | | |
| Mountain Plaza | El Paso, TX | 188 Units | \$ 5,184 | \$ 4,257 | \$ 370 | 5.16% | 12/34 |
| Paramount Terrace | Amarillo, TX | 181 Units | 3,176 | 2,663 | 323 | 5.15 | 06/37 |
| Treehouse | Irving, TX | 160 Units | 5,780 | 5,027 | 138 | 5.06 | 07/34 |
| Office Building | | | | | | | |
| 1010 Common | New Orleans, LA | 494,579 Sq. Ft. | 16,250 ⁽³⁾ | 8,000 | 7,829 | 4.03 ⁽¹⁾ | 07/07 |
| 225 Baronne | New Orleans, LA | 416,834 Sq. Ft. | 500 ⁽⁴⁾ | | | 5.75 ⁽¹⁾ | 10/05 |
| Amoco | New Orleans, LA | 378,244 Sq. Ft. | 1,500 ⁽⁴⁾ | | | 5.75 ⁽¹⁾ | 10/05 |
| Centura Tower | Farmers Branch, TX | 410,901 Sq. Ft. | 34,000 ⁽⁵⁾ | 36,889 | (4,588) | 5.50 ⁽¹⁾ | 04/04 |
| Centura Tower ⁽²⁾ | Farmers Branch, TX | 410,901 Sq. Ft. | 3,800 ⁽⁵⁾ | | 3,737 | 5.75 ⁽¹⁾ | 04/06 |
| Centura Tower | Farmers Branch, TX | 410,901 Sq. Ft. | 50,000 | 37,594 | 2,989 | 4.94 | 10/09 |
| Warehouse | | | | | | | |
| Addison Hangers I & II ⁽⁶⁾ | Addison, TX | 52,650 Sq. Ft. | 4,500 | 2,592 | 1,635 | 10.00 | 09/14 |
| Hotels | | | | | | | |
| City Suites | Chicago, IL | 45 Rooms | 3,640 | | 3,548 | 6.75 ⁽¹⁾ | 09/09 |
| Majestic Inn | San Francisco, CA | 57 Rooms | 2,000 ⁽⁴⁾ | 5,138 | (1,278) | 5.75 ⁽¹⁾ | 10/05 |
| Willows | Chicago, IL | 52 Rooms | 3,500 | | 3,411 | 6.75 ⁽¹⁾ | 09/09 |
| Land | | | | | | | |
| Centura land | Farmers Branch, TX | 8.753 Acres | 4,485 | 4,400 | (183) | 7.00 ⁽¹⁾ | 02/05 ⁽⁸⁾ |
| Cooks Lane | Ft. Worth, TX | 23.242 Acres | 550 | | 527 | 6.25 | 11/06 |
| Hollywood, Dominion & Mira Lago ⁽⁷⁾ | Farmers Branch, TX | 66.085 Acres | 6,985 | 6,222 | (67) | 7.00 ⁽¹⁾ | 02/05 ⁽⁹⁾ |

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| | | | | | | |
|---------------|--------------------|--------------|----------------------|-------|---------------------|-------|
| Lacy Longhorn | Farmers Branch, TX | 17.115 Acres | 1,965 ⁽³⁾ | 78 | 4.03 ⁽¹⁾ | 07/07 |
| Marine Creek | Ft. Worth, TX | 28.437 Acres | 1,785 ⁽³⁾ | 1,746 | 4.03 ⁽¹⁾ | 07/07 |

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- (1) Variable rate.
- (2) 2nd lien advance on Centura Tower.
- (3) The 1010 Common office building, certain tracts of Marine Creek land and the Lacy Longhorn land are cross collateralized.
- (4) The Majestic Inn, 225 Baronne Office Building and Amoco Office Building are cross collateralized. The debt incurred on 225 Baronne and Amoco are 2nd lien loans.
- (5) Debt was paid off by September 2004 refinancing.
- (6) The Addison Hangers were sold in September 2004 to a third party and were leased back for 10 years on a triple net lease basis. This transaction has been recorded as a financing transaction for accounting purposes.
- (7) The Hollywood Casino, Dominion and Mira Lago tracts are cross collateralized.
- (8) Debt was paid off in February 2005.
- (9) Debt was extended to February 2006.

Properties Held for Sale. Set forth below are TCI's properties held for sale.

| <u>Property</u> | <u>Location</u> | <u>Units</u> |
|------------------------------|-----------------|---------------------------|
| Apartments | | |
| Bay Walk | Galveston, TX | 192 Units |
| Island Bay | Galveston, TX | 458 Units |
| Marina Landing | Galveston, TX | 256 Units |
| | | <u>Square Feet</u> |
| Office Buildings | | |
| 9033 Wilshire | Los Angeles, CA | 44,253 Sq. Ft. |
| Institute Place | Chicago, IL | 144,915 Sq. Ft. |
| Industrial Warehouses | | |
| 5700 Tulane | Atlanta, GA | 67,850 Sq. Ft. |

Partnership Properties. TCI accounts for partnership properties using the equity method. TCI had no property information for properties owned by partnerships.

TCI is a 30% general partner in Sacramento Nine (SAC 9), which owned the Prospect Park #29 Office Building. In December 2004, SAC 9 sold the Prospect Park #29 office building for \$3.7 million, of which TCI received \$1.1 million after closing costs and fees. TCI recognized a gain on the sale of investment in SAC 9 of \$882,000 relating to this transaction.

In December 2004, TCI sold a 95% interest in Garden Centura, L.P. that owns the 410,901 sq. ft. Centura Tower office building located in Farmers Branch, Texas. TCI retained a non-controlling 1% general partner and 4% limited partner interest in Garden Centura, L.P. TCI will account for its investment in this partnership on the cost basis.

Provision for Asset Impairments. TCI recorded asset impairments of \$6.1 million in 2004, \$4.7 million for 2003 and \$2.6 million for 2002, representing the write down of certain operating properties to current estimated fair value. The assets for 2004 include the following properties:

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| Property | Location | Sq. Feet | Fair Value | Property Basis | Costs to | |
|------------------------|-----------------|-----------------|------------|----------------|----------|------------|
| | | | | | Sell | Impairment |
| Office Building | | | | | | |
| 225 Baronne | New Orleans, LA | 319,234 Sq. Ft. | \$ 8,500 | \$ 10,219 | \$ | \$ 1,720 |
| Harmon | Sterling, VA | 72,062 Sq. Ft. | 6,500 | 9,080 | 320 | 2,900 |
| Mimado | Sterling, VA | 35,127 Sq. Ft. | 4,000 | 5,367 | 210 | 1,577 |

The Harmon and Mimado buildings were sold and the contractual sales prices were used as fair value. The costs to sell were the estimated closing costs and commissions to be paid by TCI. It was determined that the fair value of 225 Baronne was less than the current book value due to the pending loss of the anchor tenant. It was determined that future leases on the vacated space will be below market rates and the projected future cash flows of 225 Baronne will not be sufficient to recover the current book value.

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The assets for 2003 include the following properties:

| Property | Location | Sq. Feet/ Acres | Fair Value | Property Basis | Costs to Sell | Impairment |
|------------------------|-----------------|----------------------------|-----------------------|---------------------------|--------------------------|-------------------|
| Office Building | | | | | | |
| Brandeis | Omaha, NE | 319,234 Sq. Ft. | \$ 8,821 | \$ 13,630 | \$ | \$ 4,357 |
| Land | | | | | | |
| Red Cross | Dallas, TX | 2.89 Acres | 8,500 | 7,679 | 1,019 | 198 |

Brandeis was returned to the lien holder via a Deed in Lieu of Foreclosure on February 27, 2004 and the outstanding debt and accrued interest was used as the fair value. The gross impairment for Brandeis was \$4.9 million but was reduced by \$452,000 for the minority interest portion. The Red Cross land was sold on January 30, 2004 and the actual sales price less selling costs was used as the fair value.

The assets for 2002 include the following properties:

| Property | Location | Units/ Acres | Fair Value | Property Basis | Costs to Sell | Impairment |
|------------------------|-----------------|-------------------------|-----------------------|---------------------------|--------------------------|-------------------|
| Apartments | | | | | | |
| Apple Lane | Lawrence, KS | 75 Units | \$ 1,580 | \$ 1,593 | \$ 238 | \$ 251 |
| Fairway View | El Paso, TX | 264 Units | 5,700 | 5,242 | 863 | 405 |
| Fountains of Waterford | Midland, TX | 172 Units | 1,900 | 2,006 | 285 | 391 |
| Plantation | Tulsa, OK | 138 Units | 2,545 | 3,100 | 145 | 700 |
| Sunchase | Odessa, TX | 300 Units | 4,100 | 3,479 | 746 | 125 |
| Land | | | | | | |
| Red Cross | Dallas, TX | 2.89 Acres | 8,400 | 8,348 | 758 | 707 |

The Red Cross land was under contract to sell in 2002 and the sales price was used as fair value. The fair value determined for the four apartments above were agreed upon purchase prices as part of the refinancing transaction with Metra Capital, LLC. The costs to sell were actual fees paid to refinance the properties. TCI refinanced the Plantation Apartments in May 2003, incurring a new note for \$2.3 million and discharging debt of \$1.9 million. See NOTE 7. NOTES AND INTEREST PAYABLE.

Mortgage Loans

In addition to investments in real estate, a portion of TCI's assets are invested in mortgage notes receivable, principally secured by real estate. TCI may originate mortgage loans in conjunction with providing purchase money financing of property sales. Management intends to service and hold for investment the mortgage notes in TCI's portfolio. TCI's mortgage notes receivable consist of first, wraparound and junior mortgage loans.

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Types of Mortgage Activity. TCI has originated its own mortgage loans, as well as acquired existing mortgage notes either directly from builders, developers or property owners, or through mortgage banking firms, commercial banks or other qualified brokers. Premier Funding, a related party, services TCI's mortgage notes. TCI's investment policy is described in ITEM 1. BUSINESS Business Plan and Investment Policy.

Types of Properties Securing Mortgage Notes. The properties securing TCI's mortgage notes receivable portfolio at December 31, 2004, consisted of three apartments, five office buildings, three parcels of unimproved land, various partnership and membership interests, and four unsecured loans. The Board of Directors may alter the types of properties securing or collateralizing mortgage loans in which TCI invests without a vote of stockholders. TCI's Articles of Incorporation impose certain restrictions on transactions with related parties, as discussed in ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

At December 31, 2004, TCI's mortgage notes receivable portfolio included nine mortgage loans with an aggregate principal balance of \$40.5 million secured by income-producing real estate located in the Southeast

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and Southwest regions of the continental United States, three mortgage loans with an aggregate principal balance of \$3.3 million secured by unimproved land in the Southwest region of the continental United States, six loans with a principal balance of \$6.3 million secured by partnership or membership interests and four unsecured loans with a principal balance of \$3.9 million. At December 31, 2004, 6.2% of TCI's assets were invested in notes and interest receivables.

The following table sets forth the percentages (based on the mortgage note principal balance) by property type and geographic region, of the income producing properties that serve as collateral for TCI's mortgage notes receivable at December 31, 2004. Excluded are \$13.5 million of mortgage notes that are secured by unimproved land or other security, or are unsecured. See Schedule IV to the Consolidated Financial Statements included at ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA for further details of TCI's mortgage notes receivable portfolio.

| <u>Region</u> | <u>Apartments</u> | <u>Commercial Properties</u> | <u>Total</u> |
|---------------|-------------------|----------------------------------|--------------|
| Southwest | 2.2% | 49.7% | 51.9% |
| Southeast | 4.1 | 44.0 | 48.1 |
| | 6.3% | 93.7% | 100.0% |

A summary of the activity in TCI's mortgage notes receivable portfolio during 2004 is as follows:

| | |
|--|-----|
| Mortgage notes receivable at January 1, 2004 | 12 |
| Loans paid off | (4) |
| Loans funded | 15 |
| | — |
| Mortgage notes receivable at December 31, 2004 | 23 |

During 2004, \$7.2 million was collected in full payment of three mortgage notes and \$1.6 million in principal payments were received on other mortgage notes. At December 31, 2004, 0.4% of TCI's assets were invested in mortgage notes secured by non-income producing real estate, comprised of a second lien mortgage note secured by 33 acres of unimproved land in Travis County, Texas, a second lien note secured by 13 acres of unimproved land in Harris County, Texas and a second lien note secured by 22.3 acres of unimproved land in Collin County, Texas

First Mortgage Loans. TCI invests in first mortgage notes with short, medium or long-term maturities. First mortgage loans generally provide for level periodic payments of principal and interest sufficient to substantially repay the loan prior to maturity, but may involve interest-only payments or moderate amortization of principal and a balloon principal payment at maturity. With respect to first mortgage loans, the borrower is required to provide a mortgagee's title policy or an acceptable legal title opinion as to the validity and the priority of the mortgage lien over all other obligations, except liens arising from unpaid property taxes and other exceptions normally allowed by first mortgage lenders in the relevant area. TCI may grant participations in first mortgage loans it originates to other lenders.

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The following discussion briefly describes first mortgage loans funded in 2004, as well as events during 2004 that affected previously funded first mortgage loans.

In March 2002, TCI sold the 174,513 Sq. Ft. Hartford Office Building in Dallas, Texas, for \$4.0 million and provided the \$4.0 million purchase price as seller financing and an additional \$1.4 million line of credit for leasehold improvements in the form of a first lien mortgage note. The note bears interest at a variable interest rate, currently 7.5% per annum, requires monthly interest only payments and matures in March 2007. As of March 2005, TCI has funded \$788,000 of the additional line of credit.

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Junior Mortgage Loans. TCI may invest in junior mortgage loans, secured by mortgages that are subordinate to one or more prior liens either on the fee or a leasehold interest in real estate. Recourse on such loans ordinarily includes the real estate on which the loan is made, other collateral and personal guarantees by the borrower. The Board of Directors restricts investment in junior mortgage loans, excluding wraparound mortgage loans, to not more than 10.0% of TCI's assets. At December 31, 2004, 4.2% of TCI's assets were invested in junior and wraparound mortgage loans.

The following discussion briefly describes the junior mortgage loans that TCI originated in 2004 as well as events that affected previously funded junior mortgage loans during 2004.

In August 2001, TCI agreed to fund up to \$5.6 million secured by a second lien on an office building in Dallas, Texas. The note receivable bears interest at a variable rate, currently 9.0% per annum, requires monthly interest only payments and matured in January 2003. As of March 2004, TCI has funded a total of \$4.3 million. On January 22, 2003, TCI agreed to extend the maturity date until May 1, 2003. The collateral used to secure TCI's second lien was seized by the first lien holder. On March 11, 2004, TCI agreed to accept an assignment of claims in litigation as additional security for the note. In December 2004, TCI agreed to a Modification Agreement with the borrower, which was effective November 1, 2003. As of the modified effective date, accrued interest of \$582,000 was added to the principal balance of the note, the interest rate was set to a fixed rate of 9.0% per annum and all principal and interest is due October 2005. TCI also received Pledge and Security Agreements in various partnership interests belonging to the borrower and received various Assignments of Proceeds from sales in certain entities owned by the borrower. TCI also agreed to reduce accrued interest and principal by \$1.5 million from the receipt of notes receivable assigned to TCI by borrower and by \$605,000 from cash received. TCI also received \$1.4 million in January 2005 that was applied to accrued interest and principal effective December 30, 2004. As a result of this modification, TCI has released \$1.4 million of allowance for loan losses to expense. The following notes were assigned to TCI as payment on the note:

\$678,000 from a partnership that owns an apartment building. This note is unsecured, bears no interest and has no maturity date. Distributions made from the partnership operations will be used to pay the principal on the note.

\$264,000, including accrued interest, secured by a second lien on 13 acres of unimproved land. This note bears interest at 9.0% and matured in February 2003. TCI's parent company, ARI, is in negotiations to take title to the collateral, therefore, this note is considered performing and no allowance has been established.

\$341,000 secured by a second lien on 23.3 acres of unimproved land. This note bears interest at 4.0% and is payable upon demand.

\$125,000 secured by a 100% interest in an affiliated company that owns an apartment building. This note bears interest at 12.0%, only requires payments if surplus cash is available and matures in April 2009.

In July 2002, TCI entered into an agreement to fund up to \$300,000 under a revolving line of credit secured by 100% interest in a partnership of the borrower. The line of credit bears interest at 12.0% per annum, requires monthly interest only payments and matures in June 2005. As of March 2005, TCI has funded all \$300,000 of the line of credit.

In June 2003, TCI sold the 104 unit Willow Wick Apartments in North Augusta, South Carolina, for \$2.7 million and provided \$42,000 of the purchaser's closing costs as seller financing. The note bore interest at a fixed rate of 5.0% and requires all interest and principal payments be paid at maturity in December 2003. This loan was extended until February 2004 and \$10,000 was received in March 2004. This note, including accrued but unpaid interest, was paid in June 2004. TCI agreed to discount the note \$2,000 and recognized a loss of \$2,000.

In March 2004, TCI sold 492.531 acres in Collin County, Texas to a third party for \$20.0 million. TCI provided \$7.2 million of the purchase price as seller financing for a portion of the land on a contingent basis. The

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secured note bore interest at 7% and matured in September 2004. The buyer had the option to convey the contingent land back to TCI for cancellation of the note. The purchaser extended the note to December 2004 with a \$1.1 million principal payment in September 2004. This note, including accrued but unpaid interest, was paid in December 2004.

In October 2004, TCI sold the In The Pines apartments to a third party and provided \$1.0 million of the purchase price as seller financing in the form of two notes. The first note bears interest at 7.0% per annum, requires monthly interest payments and matured in January 2005. The Purchaser extended this note to March 2005 by paying 1.0% of the outstanding principal balance as an extension fee and then extended the note an additional 30 days to April 2005 by paying an extension fee of 0.5% of the outstanding principal balance. In the event of a default, the note is also secured by membership rights in the purchaser's entity. The second note is unsecured, bears interest at 8.5% per annum, requires monthly interest payments and matured in January 2005. The Purchaser extended this note to March 2005 by paying 1.0% of the outstanding principal balance as an extension fee and then extended the note an additional 30 days to April 2005 by paying an extension fee of 0.5% of the outstanding principal balance.

Related Parties. In January 2002, TCI purchased 100% of the outstanding common shares of ART Two Hickory Corporation (Two Hickory), a wholly-owned subsidiary of ARI, a related party, for \$4.4 million cash. Two Hickory owns the 96,217 sq. ft. Two Hickory Centre Office Building in Farmers Branch, Texas. ARI has guaranteed that the asset shall produce at least a 12.0% annual return of the purchase price for a period of three years from the purchase date. If the asset fails to produce the 12.0% annual return, ARI shall pay TCI any shortfall. In addition, if the asset fails to produce the 12.0% return for a calendar year and ARI fails to pay the shortfall, TCI may require ARI to repurchase the shares of Two Hickory for the purchase price. Because ARI has guaranteed the 12.0% return and TCI has the option of requiring ARI to repurchase the entities, management has classified this related party transaction as a note receivable from ARI. In June 2002, the asset was refinanced. TCI received \$1.3 million of the proceeds as a principal reduction on its note receivable from ARI. In January 2005, TCI completed the purchase of Two Hickory by recording the asset and the assumed debt, and removing the note receivable from ARI.

In April 2002, TCI purchased 100% of the following entities: ART One Hickory Corporation (One Hickory), Garden Confederate Point, LP (Confederate Point), Garden Foxwood, LP (Foxwood), and Garden Woodsong, LP (Woodsong), all wholly-owned subsidiaries of ARI, a related party, for \$10.0 million. One Hickory owns the 120,615 sq. ft. One Hickory Centre Office Building in Farmers Branch, Texas. Confederate Point owns the 206 unit Confederate Apartments in Jacksonville, Florida. Foxwood owns the 220 unit Foxwood Apartments in Memphis, Tennessee. Woodsong owned the 190 unit Woodsong Apartments in Smyrna, Georgia. ARI has guaranteed these assets shall produce at least a 12.0% return annually of the purchase price for a period of three years from the purchase date. If the assets fail to produce the 12.0% return, ARI shall pay TCI any shortfall. In addition, if the assets fail to produce the 12.0% return for a calendar year and ARI fails to pay the shortfall, TCI may require ARI to repurchase the entities for the purchase price. Because ARI has guaranteed the 12.0% return and TCI has the option of requiring ARI to repurchase the entities, management has classified this related party transaction as a note receivable from ARI. In October 2003, TCI sold One Hickory to IORI for \$12.2 million, less prorations, for a wraparound promissory note of \$12.0 million. This note bears interest at 5.49% interest, requires monthly interest and principal payments and matures in June 2006. This transaction effectively discharged the note receivable TCI had from ARI for the financing of One Hickory. Also, in November 2003, Confederate Point sold the Confederate Apartments and paid \$2.1 million to TCI to pay off the loan and accrued but unpaid interest.

In December 2003, TCI purchased a note receivable secured by 33 acres of raw land in Travis County, Texas from ARI for \$2.4 million, which reduced ARI's affiliate payable to Prime and TCI. The note bears interest at 10.0% per annum, requires interest only payments beginning in November 2007 and matures in October 2008. Outstanding accrued interest is added to the principal balance on an annual basis until 2007. During 2004, \$240,000 of accrued interest was added to the principal balance of the note.

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In December 2003, TCI sold a tract of Marine Creek land to a subsidiary of United Housing Foundation, Inc. (UHF) for \$1.5 million, receiving cash and a note receivable. This sale was not recognized due to UHF being a related party and TCI having continuing involvement and control. In February 2004, Marine Creek was refinanced by UHF, which paid off TCI's note payable on the land. TCI recorded the sale of the land and received a note receivable of \$270,000, which was the difference between the sales price and the amount of TCI's note payable. The note bears interest at 6.0%, requires quarterly payments from available surplus cash and matures in December 2007. See Note 8. RELATED PARTY TRANSACTIONS.

In October 2004, TCI sold the Durham Centre in Durham, North Carolina to a partnership, of which the managing general partner is a subsidiary of ARI, for \$21.3 million for cash and an all-inclusive wraparound note of \$14.5 million. The note bears interest at a fixed rate of 7.63%, requires monthly interest payments and matures in September 2007. TCI also made a loan to the partnership for \$3.3 million. The note bears interest at a fixed rate of 7.63%, requires monthly interest payments and matures in September 2017.

In October 2004, TCI contemplated the sale of the common stock of TCI Lexington Corporation, which owns the Lexington Center office building in Colorado Springs, Colorado, to One Realco Office Investors, Inc., a related party, for the assumption of debt of \$4.9 million, which was subject to lender approval, and a seller note of \$237,000. The assumption of debt by One Realco Office Investors, Inc. was not approved by the lender; therefore, TCI's Board of Directors rescinded their approval of the transaction. TCI extended the loan on the Lexington Center with the lender in December 2004.

Other. In July 2003, TCI advanced \$2.3 million to the Class A Limited Partners of TCI Countryside, L.P. of which TCI is the general partner. This loan bears interest at 7.25% and matures in January 2007. TCI also agreed to advance \$1.1 million to the Class A Limited Partners by advancing \$105,000 in July 2003 and every year thereafter for ten years. This loan bears interest at 7.25% and matures in July 2012. Interest due to TCI will be deducted for the quarterly return owed by TCI to the Class A Limited Partners, eliminating the quarterly payments. After January 2007, TCI may retire the Class A Limited Partners interests in exchange for cancellation of both notes, subject to the \$1.1 million advance being fully advanced by TCI.

In March 2004, TCI sold the Texstar Warehouse in Arlington, Texas to BCM for \$2.4 million, including the assumption of debt. TCI also provided \$1.3 million of the purchase price as seller financing. The unsecured note bears interest at the prime rate plus 2%, which is currently 7.75%, and matures in April 2005.

In March 2004, TCI sold a K-Mart in Cary, North Carolina to BCM for \$3.2 million, including the assumption of debt. TCI also provided \$1.5 million of the purchase price as seller financing. The unsecured note bears interest at the prime rate plus 2%, which is currently 7.75%, and matures in April 2005.

Partnership mortgage loans. TCI owns a 60.0% general partner interest and IORI owns a 40.0% general partner interest in Nakash Income Associates (NIA), which owns a wraparound mortgage note receivable secured by a building occupied by a Wal-Mart in Maulden, Missouri.

ITEM 3. LEGAL PROCEEDINGS

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Innovo Realty, Inc. On August 10, 2004, American Realty Investors, Inc. (ARI), TCI and Income Opportunity Realty Investors, Inc. (IOT) instituted an action in Texas State District Court as Cause No. 2004-60231-393 styled *American Realty Investors, Inc., Transcontinental Realty Investors, Inc. and Income Opportunity Realty Investors, Inc., Plaintiffs v. Innovo Realty, Inc. and Innovo Group, Inc., Involuntary Plaintiffs v. Innovo Realty, Inc., Metra Capital LLC, Innovo Group, Inc., Joseph Mizrahi, Simon Mizrahi, Hubert Guez, Third Millennium Partners LLC, Third Millennium Partners, Inc., Third Millennium Group LLC and Sunridge Management Group, Inc., Defendants.* Plaintiffs Complaint alleges that Joseph Mizrahi, a former director of ARI and others, offered a plan to the Plaintiffs to create one or more joint venture arrangements with one or more of the Plaintiffs to pursue alternative forms of financing or refinancing portions of Plaintiffs real

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estate portfolios, which entailed the creation of 22 separate limited partnerships to acquire 28 separate apartment complexes in three states (Texas, Florida and Louisiana), the general partners of which are affiliates of, or controlled by, Joseph Mizrachi. Plaintiffs' Complaint alleges that the overall transaction required the establishment of a sinking fund by the Defendants and the 22 limited partnerships as a trust for the benefit of certain preferred shareholders of Innovo Group, Inc. and the payment of certain proceeds to the Plaintiffs. Plaintiffs assert that payments have not been made pursuant to the agreement of the parties. Plaintiffs allege that Defendants' conduct constituted a common business enterprise, alleges breach of contract and derivative claims on behalf of Innovo Group, Inc. against Joseph Mizrachi and others, and requests declaratory relief involving the Plaintiffs' rights in the partnerships, an accounting of proceeds, and the creation of a constructive trust. Plaintiffs' Complaint also alleges that Joseph Mizrachi engaged in fraud, negligent misrepresentation and/or breach of fiduciary duty and seeks unspecified damages, attorneys' fees, the establishment of a constructive trust and other relief.

Sunset Management, LLC. On October 5, 2004, Sunset Management LLC (Sunset) filed a Complaint as a purported stockholder's derivative action on behalf of Transcontinental Realty Investors, Inc. in the United States District Court for the Northern District of Texas, Dallas Division, against American Realty Investors, Inc., Basic Capital Management, Inc. (BCM), Prime Income Asset Management, Inc. (PIAMI), Prime Income Asset Management LLC (Prime), Income Opportunity Realty Investors, Inc., United Housing Foundation, Inc. (United), Regis Realty, Inc. (Regis), TCI, TCI's current directors and officers and others. Sunset's Complaint was instituted as Case No. 3:04-CV-02162-B styled *Sunset Management LLC, Derivatively on Behalf of Transcontinental Realty Investors, Inc. v. American Realty Investors, Inc., et al.* Sunset's Complaint alleges (i) Sunset is the owner of 10 shares of Common Stock of TCI and Sunset is the pledgee and beneficial owner of 3,673,115 shares of Common Stock of TCI, (ii) Sunset is a single-member limited liability company, (iii) all of the Defendants have in their various capacities breached fiduciary duties to TCI, and (iv) unjust enrichment of the various Defendants. Sunset's Complaint seeks an injunction prohibiting TCI from entering into any related-party transactions that are not fair to TCI and approved by disinterested directors and/or the stockholders of TCI with full knowledge of the common interest of the directors and/or officers, unspecified damages, attorneys' fees and costs. Individual directors and officers of TCI do not believe their interests are adverse to TCI in this matter. All Defendants believe the action is not properly brought as a derivative action on behalf of TCI, as Sunset's interests are adverse to the interests of TCI. The current action brought by Sunset contains many of the same allegations raised by Sunset in four other cases which, as rulings have occurred, have resulted in a denial of Sunset's requested relief. The Defendants intend to vigorously defend the action, and on November 8, 2004, filed a Motion to Dismiss the case pursuant to Rules 12 and 23.1 of the Federal Rules of Civil Procedure on the basis that Sunset's allegations are insufficient to evade the stringent demand requirement under the futility exception for stockholder derivative actions, and that Sunset cannot fairly and adequately represent the interests of other stockholders. On January 4, 2005, the Defendants also filed a Motion to Stay Discovery and for Protective Order based on the concept that the Motion to Dismiss should dispose of the matter. No hearing has been held or Order issued by the Court on either Motion through March 31, 2005. Separately, one of the individual Defendants filed on January 4, 2005, a Motion to Disqualify Sunset's Counsel.

The current Sunset Complaint is the fifth in a continuing series of actions involving Sunset, certain subsidiaries of ARI and ARI resulting from a loan in September 2001 to BCM and three subsidiaries of ARI in the original amount of \$30 million (\$19.5 million of which bore interest at 24% per annum, while the remaining \$10.5 million of which bore interest at 20%). In September 2002, \$15 million in principal was repaid leaving a \$15 million aggregate balance, which Sunset orally agreed to extend the maturity date and accept substitute collateral, an arrangement which Sunset did not honor, resulting in the original litigation filed in Texas State Court during October 2002 as Cause No. 02-09433-I in the 162nd Judicial District Court of Dallas County, Texas styled *American Realty Trust, Inc., ART Williamsburg, Inc., Basic Capital Management, Inc. and EQK Holdings, Inc. v. Sunset Management LLC* (the Texas Litigation). The Texas Litigation alleged breach of contract, misrepresentation, breach of duty of good faith and fair dealing and slander of title by Sunset and sought certain declaratory relief against Sunset, as well as temporary and permanent anti-suit injunction against Sunset.

During January 2003, without notice to the Plaintiffs in the Texas Litigation, Sunset instituted an action in Federal District Court in Las Vegas, Nevada against Commonwealth Land Title (Commonwealth) seeking

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disposition of certain shares of Common Stock of TCI held by Commonwealth as Pledge Holder. On January 31, 2003, after a Temporary Restraining Order was issued in the Texas Litigation against Sunset, Sunset instituted a separate lawsuit in Nevada State Court styled *Sunset Management LLC v. American Realty Trust, Inc., et al.*, Cause No. A462587 pending in District Court of Clark County, Nevada (the Nevada Litigation). On February 12, 2003, the Nevada State Court held a hearing on Sunset's request for emergency relief and denied all of Sunset's requested relief and indicated that a stay of the Nevada Litigation may be appropriate, which stay of litigation (including claims against TCI) was granted on May 2, 2003. Notwithstanding the stay of the Nevada Litigation, Sunset has attempted to re-litigate the underlying issues already determined in the Texas Litigation and the Nevada Litigation through cross-claims and counterclaims in the Texas Litigation and renewed motions for injunctions and the appointment of a receiver in the Nevada Litigation. During September 2003, the Texas Litigation was removed to Bankruptcy Court for the Northern District of Texas and subsequently transferred to the Eastern District of Texas. Sunset and the Plaintiffs have filed cross-motions for partial summary judgment in the Bankruptcy Court which had been briefed but remain pending at this time. The parties have also filed an Agreed Motion to Withdraw the reference and have the case transferred to a United States District Judge for trial, which has been denied without prejudice pending resolution of pre-trial motions, including the motions for summary judgment.

On February 10, 2004, Sunset filed yet another lawsuit in Nevada styled *Sunset Management LLC v. Transcontinental Realty Investors, Inc.*, Case No. CV04-00345 in the Superior Court of Washoe County, seeking to compel a new election of directors, alleging that Sunset was improperly denied voting rights with respect to certain pledged shares at the 2003 stockholders meeting of TCI. TCI responded to that action by informing the Nevada Court that the issue of the validity and effectiveness of proxies purportedly held by Sunset in connection with the loan was already pending before the Bankruptcy Court. On May 12, 2004, the Nevada District Court denied Sunset's motion to compel an election of corporate directors because of the dispute pending in the Texas Bankruptcy Court concerning the status of the loan. Subsequently, the Nevada District Court denied two motions for reconsideration filed by Sunset. Sunset is currently appealing the rulings of the Washoe County District Court.

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 operations or liquidity.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Annual Meeting of Stockholders was held on November 22, 2004, at which meeting stockholders were asked to consider and vote upon the election of Directors and the ratification of the selection of the independent public accountants for TCI for the fiscal year ending December 31, 2004. At the meeting, stockholders elected the following individuals as Directors:

| <u>Director</u> | <u>Shares Voting</u> | |
|-----------------|----------------------|------------------|
| | <u>For</u> | <u>Abstained</u> |
| Henry A. Butler | 7,322,494 | 9,553 |
| Sharon Hunt | 7,320,059 | 11,988 |
| Ted R. Munselle | 7,322,321 | 9,726 |
| Ted P. Stokely | 7,320,465 | 11,582 |
| Martin L. White | 7,320,598 | 11,449 |

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There were no no votes or broker non-votes on the election of Directors. With respect to the ratification of the appointment of Farmer, Fuqua & Huff, P.C. as independent auditors of the Company for the fiscal year ending December 31, 2004, and any interim period, at least 7,320,494 votes were received in favor of such proposal, 8,335 votes were received against such proposal, and 3,218 votes abstained.

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TCI's Common Stock is traded on the New York Stock Exchange (NYSE) using the symbol TCI . The following table sets forth the high and low sales prices as reported in the consolidated reporting system of the NYSE.

| <u>Quarter Ended</u> | <u>High</u> | <u>Low</u> |
|---|-------------|------------|
| March 31, 2005 (through March 24, 2005) | \$ 20.10 | \$ 14.20 |
| March 31, 2004 | 17.33 | 14.42 |
| June 30, 2004 | 14.59 | 10.99 |
| September 30, 2004 | 13.75 | 12.40 |
| December 31, 2004 | 14.59 | 13.55 |
| March 31, 2003 | 18.55 | 16.43 |
| June 30, 2003 | 18.92 | 13.99 |
| September 30, 2003 | 16.70 | 11.79 |
| December 31, 2003 | 16.73 | 11.79 |

As of March 24, 2005, the closing price of TCI's Common Stock as reported in the consolidated reporting system of the NYSE was \$19.29 per share.

As of March 24, 2005, TCI's Common Stock was held by 4,464 holders of record.

TCI paid no dividends in 2004, 2003 or 2002, and management believes no dividends will be paid in 2005. The payment of dividends, if any, will be determined by the Board of Directors in light of conditions then existing, including the Company's financial condition and requirements, future prospects, restrictions in financing agreements, business conditions and other factors deemed relevant by the Board of Directors.

In December 1989, the Board of Directors approved a share repurchase program, authorizing the repurchase of a total of 687,000 shares of TCI's Common Stock. In October 2000, the Board increased this authorization to 1,409,000 shares. Through December 31, 2004, a total of 1,189,910 shares have been repurchased at a cost of \$15.9 million. No shares were repurchased in 2002 or 2003. In November 2004, the Board approved a private block purchase of 212,800 shares of Common Stock for a total cost of \$3.1 million. The following table represents shares repurchased during each of the three months ended December 31, 2004:

| <u>Period</u> | <u>Total Number of</u> | <u>Average Price</u> | <u>Total Number of</u> | <u>Maximum Number of</u> |
|---------------|------------------------|----------------------|------------------------|--------------------------|
|---------------|------------------------|----------------------|------------------------|--------------------------|

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| | <u>Shares Purchased</u> | <u>Paid per Share</u> | <u>Shares Purchased as Part of Publicly Announced Program</u> | <u>Shares that May Yet be Purchased Under the Program^(a)</u> |
|----------------------------------|-------------------------|-----------------------|---|---|
| Balance as of September 30, 2004 | | \$ | | 431,890 |
| October 1-31, 2004 | | | | 431,890 |
| November 1-30, 2004 | 212,800 | 14.50 | 212,800 | 219,090 |
| December 1-31, 2004 | | | | 219,090 |
| Total | 212,800 | \$ 14.50 | 212,800 | 219,090 |

(a) On June 23, 2000, the TCI Board of Directors approved a share repurchase program for up to 1,409,000 shares of our common stock. This repurchase program has no termination date.

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| | For the Years Ended December 31, | | | | |
|---|--|-----------|-----------|-----------|-----------|
| | 2004 | 2003 | 2002 | 2001 | 2000 |
| | As Restated | | | | |
| | (dollars in thousands, except per share) | | | | |
| EARNINGS DATA | | | | | |
| Rents | \$ 92,959 | \$ 77,801 | \$ 61,750 | \$ 58,909 | \$ 79,044 |
| Property expense | 59,177 | 55,762 | 45,911 | 36,356 | 48,689 |
| Operating income | 33,782 | 22,039 | 15,839 | 22,553 | 30,355 |
| Gain on land sales | 7,110 | 1,641 | 666 | | |
| Income from operations | 40,892 | 23,680 | 16,505 | 22,553 | 30,355 |
| Other income | 6,507 | 11,584 | 313 | 2,924 | 1,814 |
| Gain on real estate | | | | 48,333 | 50,550 |
| Total other income | 6,507 | 11,584 | 313 | 73,810 | 82,719 |
| Other expense | 69,571 | 52,453 | 49,932 | 50,674 | 55,068 |
| Income (loss) from before tax | (22,172) | (17,189) | (33,114) | 23,136 | 27,651 |
| Income tax benefit | 10,976 | | | | |
| Net income/(loss) from continuing operations | (11,196) | (17,189) | (33,114) | 23,136 | 27,651 |
| Discontinued operations, net of taxes | 34,902 | 17,862 | 37,965 | (3,325) | 2,131 |
| Net income (loss) | 23,706 | 673 | 4,851 | 19,811 | 29,782 |
| Preferred dividend requirement | (210) | (126) | (190) | (172) | (22) |
| Net income (loss) applicable to Common shares | \$ 23,496 | \$ 547 | \$ 4,661 | \$ 19,639 | \$ 29,760 |
| Basic and Diluted Earnings Per Share | | | | | |
| Basic | \$ 2.90 | \$.07 | \$.58 | \$ 2.32 | \$ 3.45 |
| Diluted | \$ 2.90 | \$.07 | \$.58 | \$ 2.28 | \$ 3.45 |
| Dividends per Common share | \$ | \$ | \$ | \$ | \$.54 |
| Weighted Average Common Shares Outstanding | | | | | |
| Basic | 8,082,854 | 8,078,108 | 8,057,361 | 8,478,377 | 8,631,621 |
| Diluted | 8,082,854 | 8,078,108 | 8,057,361 | 8,615,465 | 8,637,290 |

| | For the Years Ended December 31, | | | | |
|---------------------------|--|------|------|------|------|
| | 2004 | 2003 | 2002 | 2001 | 2000 |
| | As Restated | | | | |
| | (dollars in thousands, except per share) | | | | |
| BALANCE SHEET DATA | | | | | |

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| | | | | | |
|---------------------------------------|------------|------------|------------|------------|------------|
| Real estate held for investment, net | \$ 658,300 | \$ 641,022 | \$ 736,977 | \$ 622,171 | \$ 639,040 |
| Real estate held for sale | 49,878 | 61,457 | 22,510 | 516 | 1,824 |
| Real estate subject to sales contract | 70,350 | 79,848 | | | |
| Notes and interest receivable, net | 56,630 | 30,741 | 27,953 | 22,049 | 8,172 |
| Total assets | 920,311 | 882,784 | 858,489 | 709,152 | 731,885 |
| Notes and interest payable | 644,071 | 626,465 | 586,628 | 461,037 | 501,734 |
| Stockholders' equity | 240,519 | 221,758 | 222,394 | 216,768 | 200,560 |
| Book value per share | \$ 30.44 | \$ 27.33 | \$ 27.55 | \$ 26.95 | \$ 23.22 |

TCI purchased 20 properties for a total of \$86.7 million in 2004, 10 properties for a total of \$36.9 million in 2003, 16 properties for a total of \$107.7 million in 2002, 17 properties for a total of \$62.5 million in 2001, and

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18 properties for a total of \$103.9 million in 2000. TCI sold 20 properties, the two remaining warehouses in the Kelly portfolio and four parcels of land for \$276.7 million in 2004, 13 properties, two warehouses in the Kelly portfolio and 5 parcels of land for \$86.6 million in 2003, 18 properties and a partial land parcel for a total of \$117.6 million in 2002, 22 properties, one warehouse in the Kelly portfolio and three partial land parcels in 2001 for a total of \$161.5 million, and 20 properties in 2000 for a total of \$113.5 million. See ITEM 2. PROPERTIES Real Estate and ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Introduction

TCI invests in real estate through acquisitions, leases and partnerships and in mortgage loans on real estate, including first, wraparound and junior mortgage loans. TCI is the successor to a California business trust organized on September 6, 1983, which commenced operations on January 31, 1984. On November 30, 1999, TCI acquired all of the outstanding shares of beneficial interest of CMET, a real estate company, in a tax-free exchange of shares, issuing 1.181 shares of its Common Stock for each outstanding CMET share. TCI accounted for the merger as a purchase.

Prior to January 1, 2000, TCI elected to be treated as a Real Estate Investment Trust (REIT) under Sections 856 through 860 of the Internal Revenue Code of 1986, as amended (the Code). During the third quarter of 2000, TCI no longer met the requirement for tax treatment as a REIT due to a concentration of ownership.

Critical Accounting Policies

Critical accounting policies are those that are both important to the presentation of TCI's financial condition and results of operations and require management's most difficult, complex or subjective judgments. TCI's critical accounting policies relate to the evaluation of impairment of long-lived assets and the evaluation of the collectibility of accounts and notes receivable.

If events or changes in circumstances indicate that the carrying value of a rental property to be held and used or land held for development may be impaired, management performs a recoverability analysis based on estimated undiscounted cash flows to be generated from the property in the future. If the analysis indicates the carrying value is not recoverable from future cash flows the property is written down to estimated fair value and an impairment loss is recognized. If management decides to sell rental properties or land held for development, management evaluates the recoverability of the carrying amounts of the assets. If the evaluation indicates the carrying value is not recoverable from estimated net sales proceeds, the property is written down to estimated fair value less costs to sell and an impairment loss is recognized within income from continuing operations. TCI's estimates of cash flow and fair values of the properties are based on current market conditions and consider matters such as rental rates and occupancies for comparable properties, recent sales data for comparable properties and, where applicable, contracts or the results of negotiations with purchasers or prospective purchasers. TCI's estimates are subject to revision as market conditions and TCI's assessments of them change. In the third quarter of 2004, TCI recognized \$1.6 million and \$2.9 million of impairment losses, and in the fourth quarter of 2004, recognized \$1.7 million of impairment losses. In the fourth quarter of 2003, TCI recognized \$4.4 million and \$192,000 as impairment losses, and in the second and third quarter of 2002, TCI recognized \$1.9 million and \$700,000 as impairment losses.

TCI's allowance for doubtful accounts receivable and notes receivable is established based on analysis of the risk of loss on specific accounts. The analysis places particular emphasis on past due accounts. Management considers such information as the nature and age of the receivable, the payment history of the tenant or other debtor, the financial condition of the tenant or other debtor and TCI's assessment of its ability to meet its lease or interest obligations. TCI's estimate of the required allowance, which is reviewed on a quarterly basis, is subject to revision as these factors change and is sensitive to the effects of economic and market conditions.

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TCI's management periodically discusses criteria for estimates and disclosure of its estimates with the audit committee of TCI's Board of Directors.

Obligations and Commitments

TCI has contractual obligations and commitments primarily with regards to the payment of mortgages.

The following table aggregates TCI's expected contractual obligations and commitments subsequent to December 31, 2004.

| | PAYMENTS DUE BY PERIOD | | | | |
|-------------------------------|-------------------------------|-------------------------|------------------|------------------|--------------------------|
| | Total | Less than 1 Year | 1-3 Years | 3-5 Years | More than 5 Years |
| | (Dollars in thousands) | | | | |
| Long-Term Debt ⁽¹⁾ | \$ 640,011 | \$ 188,152 | \$ 117,535 | \$ 49,038 | \$ 285,286 |
| Capital Lease Obligations | | | | | |
| Operating Leases | | | | | |
| Purchase Obligations | | | | | |
| Other Long-Term Liabilities | 2,171 | 2,171 | | | |

(1) TCI's long-term debt may contain financial covenants that, if certain thresholds are not met, could allow the lender to accelerate principal payments or cause the note to become due immediately.

Other long-term liabilities represent TCI's intentions to purchase the interests of general and limited partners formed to construct residential properties.

Liquidity and Capital Resources

Cash and cash equivalents were \$21.8 million, \$6.4 million, and \$10.6 million at December 31, 2004, 2003 and 2002, respectively. The principal reasons for the change in cash are discussed in the paragraphs below.

TCI's principal sources of cash have been and will continue to be from property operations, proceeds from property sales, and the collection of mortgage notes receivable, borrowings and to a lesser extent, distributions from partnerships. Management anticipates that TCI's cash at December 31, 2004, along with cash that will be generated in 2005 from property operations, will not be sufficient to meet all of TCI's cash requirements. Management intends to selectively sell income producing real estate, refinance or extend real estate debt and seek additional borrowings against real estate to meet its cash requirements. Historically, management has been successful at extending its current maturity obligations. Management also anticipates funding ongoing real estate construction projects and the acquisition of new real estate from cash generated by property sales, debt refinancings or extensions, and additional borrowings.

Net cash used in operations was \$13.2 million in 2004 compared to net cash provided in operations of \$3.7 million in 2003 and net cash used of \$9.1 million in 2002. Cash flow from property operations is rents collected, less payment for property operating expenses or net rental income. Although operating income was higher in 2004 compared to 2003 due to increased income from residential properties, cash from operations was less in 2004 compared to 2003 due to higher spending on general and administrative expenses, advisory fees and net income fees and an increase in non-cash gains from property sales and foreign currency transactions in 2004 compared to 2003. The increase in operating cash from 2002 to 2003 was due to an increase in net rental income from new apartments that finished construction in 2002 and 2003, and an increase in commercial net rental income due to Centura Tower, which was purchased in June 2002. Cash also increased due to less spending on general and administrative expenses from 2002 to 2003. These gains were offset by the sales of real estate during 2002 and 2003 and from higher interest expense paid during 2003. Management believes that cash flow may decrease from property operations as a result of selling income producing properties.

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Management expects that funds from existing cash resources, selective sales of income producing properties, refinancing of real estate, and additional borrowings against real estate will be sufficient to meet TCI's cash requirements associated with its current and anticipated level of operations, maturing debt obligations and existing commitments. To the extent that TCI's liquidity permits or financing sources are available, management intends to make new real estate investments.

Net cash used in investing activities was \$18.9 million in 2004 compared to \$26.9 million in 2003 and \$67.0 million in 2002. Cash from investing activities increased in 2004 compared to 2003 due to higher proceeds from the sales of real estate and collections on notes receivable, reduced by increased spending on real estate construction and improvements and real estate acquisitions, and an increase in payments to TCI's advisor. Cash from investing activities increased in 2003 compared to 2002 due to TCI spending less on real estate construction and improvements and an increase in payments received from TCI's advisor. These cash increases were offset by cash decreases due to less collected on notes receivable, less real estate sold, the purchase of marketable securities and increases in deposits on pending real estate purchases.

Net cash provided by financing activities was \$47.6 million in 2004 compared to \$19.0 million in 2003 and \$76.3 million in 2002. Cash from financing activities increased in 2004 compared to 2003 due to higher proceeds from refinancing of notes payable, which was reduced by higher payments on notes payable and the repurchase of TCI's common stock. Cash from financing activities decreased in 2003 compared to 2002 due to higher payments on notes payable and lower proceeds from notes payable refinancings.

Management reviews the carrying values of TCI's properties and mortgage notes receivable at least annually and whenever events or a change in circumstances indicate that impairment may exist. Impairment is considered to exist if, in the case of a property, the future cash flow from the property (undiscounted and without interest) is less than the carrying amount of the property. For notes receivable, impairment is considered to exist if it is probable that all amounts due under the terms of the note will not be collected. If impairment is found to exist, a provision for loss is recorded by a charge against earnings. The note receivable review includes an evaluation of the collateral property securing such note. The property review generally includes: (1) selective property inspections; (2) a review of the property's current rents compared to market rents; (3) a review of the property's expenses; (4) a review of maintenance requirements; (5) a review of the property's cash flow; (6) discussions with the manager of the property; and (7) a review of properties in the surrounding area.

Results of Operations

2004 Compared to 2003. TCI had net income of \$23.1 million in 2004, including gains on sale of real estate totaling \$63.3 million and net income of \$673,000 in 2003, including gains on sale of real estate totaling \$21.7 million. Fluctuations in the components of revenues and expense between 2004 and 2003 are discussed below.

Rents were \$93.0 million in 2004 compared to \$77.8 million in 2003. The increase in rents from 2004 to 2003 is primarily due to new rental income from completed apartment projects since 2001 and a slight increase in hotel revenues.

Property operations expenses were \$59.2 million in 2004 compared to \$55.8 million in 2003. This increase is primarily due to additional operations expense from the completion of apartment projects since 2001, which is offset by decreases in hotel and land operations during 2004.

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Interest and other income was \$3.7 million in 2004 compared to \$6.7 million in 2003. The higher other income in 2003 was due to a \$3.8 million litigation settlement received by TCI.

Equity losses of investees was \$1.5 million in 2004 compared to \$4.3 million in 2003. The losses from equity investees are primarily attributed to operating losses for IORI and ARI. IORI and ARI had lower losses from continuing operations in 2004.

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Gain on settlement of debt was \$4.4 million in 2003. The gain resulted from a favorable ruling in a lender dispute regarding the mortgage loans on three office buildings in New Orleans, Louisiana.

Gain on condemnation award was \$4.8 million in 2003, resulting from the settlement of a dispute regarding a land parcel in Dallas, Texas.

Gain on foreign currency transaction was \$3.8 million in 2004. Gain or loss on foreign currency transaction is the result of Hotel Akademia converting long-term debt, which is denominated in Euros, into the functional currency, the Polish Zloty. The Euro weakened against the Zloty during 2004, which has resulted in TCI recognizing this gain.

Interest expense was \$32.4 million in 2004 compared to \$23.7 million in 2003. Interest expense increased in 2004 primarily due to increased debt due to apartment construction projects being completed since 2001. Changes in other segments interest expense was nominal from 2004 to 2003.

Depreciation expense was \$17.7 million in 2004 compared to \$13.2 million in 2003. Depreciation expense increased in 2004 primarily due to apartment construction projects being completed since 2001.

TCI recorded asset impairments of \$1.7 million in 2004 and \$198,000 in 2003, representing the write-down of certain operating properties to current estimated fair value.

The assets for 2004 include the following properties:

| <u>Property</u> | <u>Location</u> | <u>Sq. Feet</u> | <u>Fair Value</u> | <u>Property Basis</u> | <u>Costs to Sell</u> | <u>Impairment</u> |
|------------------------|-----------------|-----------------|-------------------|-----------------------|----------------------|-------------------|
| Office Building | | | | | | |
| 225 Baronne | New Orleans, LA | 416,834 Sq. Ft. | \$ 8,500 | \$ 10,219 | \$ | \$ 1,720 |

It was determined that the fair value of 225 Baronne was less than the current book value due to the pending loss of the anchor tenant. It was determined that future leases on the vacated space will be below market rates and the projected future cash flows of 225 Baronne will not be sufficient to recover the current book value.

The assets for 2003 include the following properties:

| <u>Property</u> | <u>Location</u> | <u>Acres</u> | <u>Impairment</u> |
|-----------------|-----------------|--------------|-------------------|
|-----------------|-----------------|--------------|-------------------|

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| | | | Fair Value | Property Basis | Costs to Sell | |
|-------------|------------|------------|---------------|-------------------|------------------|-----|
| Land | | | | | | |
| Red Cross | Dallas, TX | 2.89 Acres | 8,500 | 7,679 | 1,019 | 198 |

The Red Cross land was sold on January 30, 2004 and the actual sales price less selling costs was used as the fair value.

Advisory fee expense was \$6.7 million in 2004 compared to \$4.9 million in 2003. The increase in 2004 was due to higher average gross assets during the year. Also, TCI received an operating expense refund from Prime of \$1.3 million in 2003. See NOTE 12. ADVISORY AGREEMENT.

Net income fee to affiliate was \$1.9 million in 2004. The net income fee is payable to TCI's advisor based on 7.5% of TCI's net income. TCI had a net loss for 2003, so no net income fee was due.

General and administrative expenses were \$9.3 million in 2004 compared to \$9.1 million in 2003. The increase in 2004 was due to an increase in state income taxes and cost reimbursements to the Advisor, offset by lower legal cost and professional fees.

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Loss on foreign currency transaction was \$3.3 million in 2003. Loss on foreign currency transaction is the result of Hotel Akademia converting long-term debt, which is denominated in Euros, into the functional currency, the Polish Zloty. The Euro strengthened against the Zloty during 2003, which has resulted in TCI recognizing this charge.

Income from discontinued operations was \$58.4 million in 2004 compared to \$17.9 million in 2003. Income from discontinued operations relates to 22 operating properties sold during 2004, three apartments, two office buildings and one industrial warehouse designated as held for sale and 15 operating properties TCI sold during 2003. The following table summarizes revenue and expense information for these properties sold and held-for-sale.

| | <u>2004</u> | <u>2003</u> |
|--|------------------|------------------|
| Revenue | | |
| Rental | \$ 26,697 | \$ 46,373 |
| Property operations | 15,887 | 23,556 |
| | <u>10,810</u> | <u>22,817</u> |
| Expenses | | |
| Interest | 10,309 | 19,413 |
| Depreciation | 4,878 | 7,688 |
| | <u>15,187</u> | <u>27,101</u> |
| Net income (loss) from discontinued operations before gains on sale of real estate | (4,377) | (4,284) |
| Gain on sale of operations | 63,348 | 21,650 |
| Write-down of assets held for sale | (4,477) | (4,357) |
| Equity in investees gain on sale of real estate | 3,884 | 4,853 |
| Income from discontinued operations | <u>\$ 58,378</u> | <u>\$ 17,862</u> |

Discontinued operations have not been segregated in the consolidated statements of cash flows. Therefore, amounts for certain captions will not agree with respective consolidated statements of operations.

In 2004 and 2003, gains on sale of real estate totaling \$63.3 million and \$21.7 million were recognized. See NOTE 2. REAL ESTATE.

2003 Compared to 2002. TCI had net income of \$673,000 in 2003, including gains on sale of real estate totaling \$21.7 million and net income of \$4.9 million in 2002, including gains on sale of real estate totaling \$38.3 million. Fluctuations in the components of revenues and expense between 2003 and 2002 are discussed below.

Rents were \$77.8 million in 2003 compared to \$62.2 million in 2002. The increase in rents from 2003 to 2002 is due to new rental income from completed apartment projects and increases in commercial rents and hotel revenues.

Property operations expenses were \$55.8 million in 2003 compared to \$46.3 million in 2002. This increase is primarily due to additional operations expense from the completion of multiple apartment projects during 2001 and 2002.

Interest and other income was \$6.7 million in 2003 compared to \$4.1 million in 2002. The increase in 2003 was due to a \$3.8 million litigation settlement received by TCI.

Equity losses of investees was \$4.3 million in 2003 compared to \$3.8 million in 2002. The losses from equity investees are primarily attributed to operating losses for IORI and ARI.

Gain on settlement of debt was \$4.4 million in 2003. The gain resulted from a favorable ruling in a lender dispute regarding the mortgage loans on three office buildings in New Orleans, Louisiana.

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Gain on condemnation award was \$4.8 million in 2003, resulting from the settlement of a dispute regarding a land parcel in Dallas, Texas.

Interest expense was \$23.7 million in 2003 compared to \$20.4 million in 2002. Interest expense increased in 2003 primarily due to increased debt due to apartment construction projects being completed in 2001 and 2002, offset by a decrease in commercial interest expense during 2003.

Depreciation expense was \$13.2 million in 2003 compared to \$11.7 million in 2002. Depreciation expense increased in 2003 primarily due to apartment construction projects being completed in 2001 and 2002.

TCI recorded asset impairments of \$198,000 in 2003 and \$2.6 million for 2002, representing the write-down of certain operating properties to current estimated fair value.

The assets for 2003 include the following properties:

| Property | Location | Acres | Fair Value | Property Basis | Costs to Sell | Impairment |
|-----------------|-----------------|--------------|-------------------|-----------------------|----------------------|-------------------|
| Land | | | | | | |
| Red Cross | Dallas, TX | 2.89 Acres | \$ 8,500 | \$ 7,679 | \$ 1,019 | \$ 198 |

The Red Cross land was sold on January 30, 2004 and the actual sales price less selling costs was used as the fair value.

The assets for 2002 include the following properties:

| Property | Location | Units/Acres | Fair Value | Property Basis | Costs to Sell | Impairment |
|------------------------|-----------------|--------------------|-------------------|-----------------------|----------------------|-------------------|
| Apartments | | | | | | |
| Apple Lane | Lawrence, KS | 75 Units | \$ 1,580 | \$ 1,593 | \$ 238 | \$ 251 |
| Fairway View | El Paso, TX | 264 Units | 5,700 | 5,242 | 863 | 405 |
| Fountains of Waterford | Midland, TX | 172 Units | 1,900 | 2,006 | 285 | 391 |
| Plantation | Tulsa, OK | 138 Units | 2,545 | 3,100 | 145 | 700 |
| Sunchase | Odessa, TX | 300 Units | 4,100 | 3,479 | 746 | 125 |
| Land | | | | | | |
| Red Cross | Dallas, TX | 2.89 Acres | 8,400 | 8,348 | 758 | 707 |

The Red Cross land was under contract to sell in 2002 and the sales price was used as fair value. The fair value determined for four apartments above were agreed upon purchase prices as part of the refinancing transaction with Metra Capital, LLC. The costs to sell were actual fees paid to

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refinance the properties. TCI refinanced the Plantation Apartments in May 2003, incurring a new note for \$2.3 million and discharging debt of \$1.9 million. See NOTE 7. NOTES AND INTEREST PAYABLE.

Advisory fee expense was \$4.9 million in 2003 compared to \$4.5 million in 2002. The increase in 2003 was due to higher average gross assets during the year. TCI received operating expense refunds from BCM of \$1.3 million in 2003 and \$1.4 million in 2002. See NOTE 12. ADVISORY AGREEMENT.

Net income fee to affiliate was \$374,000 in 2002. The net income fee is payable to TCI's advisor based on 7.5% of TCI's net income. TCI had a net loss for 2003, so no net income fee was due.

General and administrative expenses were \$9.1 million in 2003 compared to \$8.8 million in 2002. The increase in 2003 was due to an increase in legal fees and state income taxes, offset by lower real estate insurance premiums and cost reimbursements to the Advisor.

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Loss on foreign currency transaction was \$3.3 million in 2003 compared to \$2.5 million in 2002. Loss on foreign currency transaction is the result of Hotel Akademia converting long-term debt, which is denominated in Euros, into the functional currency, the Polish Zloty. The Euro has strengthened against the Zloty during 2002 and 2003, which has resulted in TCI recognizing this charge.

Income from discontinued operations was \$17.9 million in 2003 compared to \$37.9 million in 2002. Income from discontinued operations relates to 15 properties that TCI sold during 2003 and 18 properties that TCI sold during 2002. The following table summarizes revenue and expense information for these properties sold and held-for-sale.

| | <u>2003</u> | <u>2002</u> |
|--|------------------|------------------|
| Revenue | | |
| Rental | \$ 46,373 | \$ 60,558 |
| Property operations | 23,556 | 33,903 |
| | <u>22,817</u> | <u>26,655</u> |
| Expenses | | |
| Interest | 19,413 | 23,085 |
| Depreciation | 7,688 | 8,975 |
| | <u>27,101</u> | <u>32,060</u> |
| Net income (loss) from discontinued operations before gains on sale of real estate | (4,284) | (5,405) |
| Gain on sale of operations | 21,650 | 38,279 |
| Write-down of assets held for sale | (4,357) | |
| Equity in investees gain on sale of real estate | 4,853 | 5,013 |
| | <u>\$ 17,862</u> | <u>\$ 37,887</u> |
| Income from discontinued operations | \$ 17,862 | \$ 37,887 |

Discontinued operations have not been segregated in the consolidated statements of cash flows. Therefore, amounts for certain captions will not agree with respective consolidated statements of operations.

In 2003 and 2002, gains on sale of real estate totaling \$21.7 million and \$38.3 million were recognized. See NOTE 2. REAL ESTATE.

Related Party Transactions

Historically, TCI, ARI, IORI, and others have each engaged in and may continue to engage in business transactions, including real estate partnerships, with related parties. Management believes that all of the related party transactions represented the best investments available at the time and were at least as advantageous to TCI as could have been obtained from unrelated parties.

Operating Relationships

TCI received rents of \$69,000 in 2004, \$175,000 in 2003, and \$88,000 in 2002 from BCM for BCM's lease at Addison Hanger. BCM owns a corporate jet that is housed at the hanger and TCI has available space at the hanger.

Property Transactions

Activity in 2004 included:

In December 2003, TCI sold six properties to subsidiaries of United Housing Foundation, Inc. (UHF), a Texas Non-Profit 501(c)3 Corporation. TCI sold 10.72 acres of Marine Creek land for \$1.5 million, Limestone at Vista Ridge apartments for \$19.0 million, the Cliffs of El Dorado apartments for \$13.4 million, the Limestone

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Canyon apartments for \$18.0 million, the Sendero Ridge apartments for \$29.4 million and the Tivoli apartments for \$16.1 million. Ted Stokely, Chairman of the Board of TCI, is the General Manager of UHF. Richard Humphrey, who is employed by Regis I, an affiliate, is President of UHF. Due to UHF being considered a related party to TCI and TCI having continued involvement and control of these entities, these transactions have not been recorded as sales. Instead, these transactions will be accounted for on the deposit method and the properties and corresponding debt will continue to be consolidated by TCI. The loans on Limestone Canyon apartments and Limestone at Vista Ridge apartments were approved by their prospective lenders for transfer to the purchasing entities. TCI has guaranteed the loans on both of these transfers. Also, Marine Creek land and the Cliffs of El Dorado apartments were recognized as sales during 2004. Management is seeking lender approval on the transfer of the notes associated with the Tivoli apartments and Sendero Ridge apartments.

In January 2004, TCI purchased the Vista Ridge land tract from ARI for \$2.6 million. This transaction decreased TCI's affiliate receivable from Prime by \$2.6 million.

In February 2004, TCI incurred a debt for \$1.0 million used for the purchase of land by ARI. This transaction increased TCI's affiliate receivable from Prime by \$1.0 million.

In February 2004, TCI recorded the sale of a tract of Marine Creek land originally sold to a related party in December 2003. This transaction was not recorded as a sale for accounting purposes in December 2003 and was recorded as a TCI refinancing transaction in February 2004. TCI received \$1.2 million in cash from the related party in February 2004 as payment on the land. TCI holds a note receivable balance of \$270,000 remaining that bears interest at 12.00% and matures in April 2009. TCI recorded the sale of the Marine Creek land tract due to the payment received on the note receivable.

In May 2004, TCI purchased the Treehouse Apartments from an affiliate with a net purchase price of \$7.5 million for the assumption of debt and a note receivable, less cash received of \$498,000. The note receivable was from the sale of the Cliffs of El Dorado Apartments to a related party in 2003. At that time, the sale of the Cliffs of El Dorado Apartments was not recorded as a sale for accounting purposes. TCI recorded the sale of the Cliffs of El Dorado in May 2004 upon payment received for the Cliffs of El Dorado note receivable.

In January 2004, TCI purchased the Lacy Longhorn land tract from ARI for \$4.5 million. This transaction decreased TCI's affiliate receivable from Prime by \$4.5 million.

In June 2004, TCI sold Waters Edge IV apartments to ARI for \$5.0 million. This transaction increased TCI's affiliate receivable from Prime by \$5.0 million.

In June 2004, TCI refinanced the 1010 Common office building, Lacy Longhorn land and certain tracts of Marine Creek land. TCI paid-off an existing note payable for ARI for \$1.9 million, increasing the affiliate receivable balance from Prime by \$1.9 million.

In September 2004, TCI sold Limestone Canyon II land to a subsidiary of UHF for \$720,000 in the form of a seller note receivable. Due to no cash received and common control, TCI has elected to continue consolidating this tract of land until the requirements for a sale have been met. No sale has recognized and no note receivable has been recorded.

In December 2004, TCI purchased five tracts of land from ARI, including the LCLLP tract (45.49 acres); the Payne tract (268 acres), of which TCI owns a 50% Tenant-In-Common interest; the Rochelle I tract (10.096 acres); the Rochelle II tract (21.269 acres); and the Valley Ranch tract (29.9 acres) for \$39.1 million, including the assumption of debt. This transaction reduced TCI's affiliate receivable from Prime by \$29.1 million.

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Environmental Matters

Under various federal, state and local environmental laws, ordinances and regulations, TCI 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 TCI's business, assets or results of operations.

Inflation

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

Tax Matters

Prior to the year 2000, TCI elected and in the opinion of management, qualified to be taxed as a REIT as defined under Sections 856 through 860 of the Internal Revenue Code of 1986, as amended. During the third quarter of 2000, due to a concentration in ownership, TCI no longer met the requirements for tax treatment as a REIT under the Code. Under the Code, TCI is prohibited from re-qualifying for REIT tax status for at least five years after January 1, 2001.

ITEM 7A. *QUANTITATIVE AND QUALITATIVE DISCLOSURES REGARDING MARKET RISK*

TCI's future operations, cash flow and fair values of financial instruments are partially dependent on the then existing market interest rates and market equity prices. Market risk is the changes in the market rates and prices, and the effect of the changes on future operations. Market risk is managed by matching a property's anticipated net operating income to an appropriate financing.

TCI is exposed to interest rate risk associated with variable rate notes payable and maturing debt that has to be refinanced. TCI does not hold financial instruments for trading or other speculative purposes, but rather issues these financial instruments to finance its portfolio of real estate assets. TCI's interest rate sensitivity position is managed by TCI's capital markets department. Interest rate sensitivity is the relationship between changes in market interest rates and the fair value of market rate sensitive assets and liabilities. TCI's earnings are affected as changes in

short-term interest rates impact its cost of variable rate debt and maturing fixed rate debt. A large portion of TCI's market risk is exposure to short-term interest rates from variable rate borrowings. The impact on TCI's financial statements of refinancing fixed debt that matured during 2004 was not material. As permitted, management intends to convert a significant portion of those borrowings from variable rates to fixed rates in 2005. If market interest rates for variable rate debt average 100 basis points more in 2005 than they did during 2004, TCI's interest expense would increase, and income would decrease by \$1.5 million. This amount is determined by considering the impact of hypothetical interest rates on TCI's borrowing cost. This analysis did not consider the effects of the reduced level of overall economic activity that could exist in such an environment. Further, in the event of a change of such magnitude, management would likely take actions to further mitigate its exposure to the change. However, due to the uncertainty of the specific actions that would be taken and their possible effects, the sensitivity analysis assumes no change in TCI's financial structure.

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The following table contains only those exposures that existed at December 31, 2004. Anticipation of exposures or risk on positions that could possibly arise was not considered. TCI's ultimate interest rate risk and its effect on operations will depend on future capital market exposures, which cannot be anticipated with a probable assurance level. Dollars in thousands.

Assets

Notes receivable

| | | |
|-----------------------------------|----|-------|
| Variable interest rate-fair value | \$ | 7,444 |
|-----------------------------------|----|-------|

| | 2005 | 2006 | 2007 | 2008 | 2009 | Thereafter | Total |
|--------------------------------|----------|-------|----------|------|------|------------|-----------|
| Instrument's maturities | \$ 2,776 | \$ | \$ 4,768 | \$ | \$ | \$ | \$ 7,544 |
| Instrument's amortization | | | | | | | 959 |
| Interest | 542 | 334 | 83 | | | | |
| Average rate | 7.19% | 7.00% | 7.00% | % | % | % | |
| Fixed interest rate-fair value | | | | | | | \$ 45,802 |

| | 2005 | 2006 | 2007 | 2008 | 2009 | Thereafter | Total |
|---------------------------|-----------|-------|-----------|----------|--------|------------|-----------|
| Instrument's maturities | \$ 22,762 | \$ | \$ 20,403 | \$ 2,626 | \$ 125 | \$ 210 | \$ 46,126 |
| Instrument's amortization | 51 | 60 | 67 | 48 | | | 226 |
| Interest | 3,212 | 1,860 | 1,430 | 295 | 272 | 2,019 | 9,088 |
| Average rate | 8.66% | 7.98% | 8.13% | 7.96% | 7.69% | 7.62% | |

Liabilities

Non-trading Instruments-Equity Price Risk

Notes payable

| | | |
|-----------------------------------|----|--------|
| Variable interest rate-fair value | \$ | 77,300 |
|-----------------------------------|----|--------|

| | 2005 | 2006 | 2007 | 2008 | 2009 | Thereafter | Total |
|--------------------------------|-----------|-----------|-----------|-------|----------|------------|------------|
| Instrument's maturities | \$ 59,513 | \$ 20,020 | \$ 26,703 | \$ | \$ 6,637 | \$ 17,936 | \$ 130,809 |
| Instrument's amortization | 2,182 | 1,987 | 1,263 | 620 | 575 | 9,804 | 16,431 |
| Interest | 6,214 | 4,913 | 3,081 | 2,080 | 1,739 | 14,046 | 32,073 |
| Average rate | 5.7% | 5.4% | 5.5% | 5.8% | 5.5% | 5.4% | |
| Fixed interest rate-fair value | | | | | | | \$ 517,251 |

| | 2005 | 2006 | 2007 | 2008 | 2009 | Thereafter | Total |
|---------------------------|------------|-----------|-----------|-----------|-----------|------------|------------|
| Instrument's maturities | \$ 121,534 | \$ 29,923 | \$ 29,932 | \$ 11,566 | \$ 23,536 | \$ 40,921 | \$ 257,412 |
| Instrument's amortization | 4,923 | 4,155 | 3,552 | 3,162 | 2,942 | 216,625 | 235,359 |
| Interest | 25,234 | 24,039 | 21,087 | 19,822 | 18,773 | 326,028 | 434,983 |
| Average rate | 6.9% | 6.9% | 6.9% | 6.9% | 6.8% | 6.7% | |

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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| <u>Consolidated Balance Sheets December 31, 2004 and 2003</u> | 41 |
| <u>Consolidated Statements of Operations Years Ended December 31, 2004, 2003 and 2002</u> | 42 |
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| Financial Statement Schedules | |
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All other schedules are omitted because they are not required, are not applicable or the information required is included in the Consolidated Financial Statements or the notes thereto.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors of

Transcontinental Realty Investors, Inc.

Dallas, Texas

We have audited the accompanying consolidated balance sheet of Transcontinental Realty Investors, Inc. and Subsidiaries as of December 31, 2004, and the related consolidated statements of operations, stockholders' equity, and cash flows for the year ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 23, Transcontinental Realty Investors, Inc.'s management has indicated its intent to both sell income producing properties and refinance or extend debt secured by real estate to meet its liquidity needs.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Transcontinental Realty Investors, Inc. as of December 31, 2004, and the results of its operations and its cash flows for the year ended December 31, 2004, in conformity with U.S. generally accepted accounting principles.

Our audits were made for the purpose of forming an opinion on the consolidated financial statements taken as a whole. Schedules III and IV are presented for the purpose of complying with the Securities and Exchange Commission's rules and is not a required part of the basic consolidated financial statements. These schedules have been subjected to the auditing procedures applied in the audits of the consolidated financial statements and, in our opinion, fairly states, in all material respects, the financial data required to be set forth therein in relation to the consolidated financial statements taken as a whole.

FARMER, FUQUA & HUFF, PC

Plano, Texas

March 31, 2005

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors of

Transcontinental Realty Investors, Inc.

Dallas, Texas

We have audited the accompanying consolidated balance sheets of Transcontinental Realty Investors, Inc. and Subsidiaries as of December 31, 2003 and the related consolidated statements of operations, stockholders' equity, other comprehensive income/(loss) and cash flows for each of the two years in the period ended December 31, 2003. We have also audited the schedules listed in the accompanying index. These financial statements and schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedules based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and schedules are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements and schedules. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements and schedules. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 23, Transcontinental Realty Investors, Inc.'s management has indicated its intent to both sell income producing properties and refinance or extend debt secured by real estate, to meet its liquidity needs.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Transcontinental Realty Investors, Inc. and Subsidiaries as of December 31, 2003 and the consolidated results of their operations and their cash flows for each of the two years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

Also, in our opinion, the schedules present fairly, in all material respects, the information set forth therein.

BDO SEIDMAN, LLP

Dallas, Texas

March 30, 2004 (except for Notes 19, 20 and 21 which are as of March 31, 2005.)

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TRANSCONTINENTAL REALTY INVESTORS, INC.

CONSOLIDATED BALANCE SHEETS

| | December 31, | |
|---|--|-------------------|
| | 2004 | 2003 |
| | As Restated (dollars in thousands, except per share) | |
| Assets | | |
| Real estate held for investment | \$ 730,584 | \$ 723,933 |
| Less accumulated depreciation | (72,284) | (82,911) |
| | <u>658,300</u> | <u>641,022</u> |
| Real estate held for sale | 49,878 | 61,457 |
| Real estate subject to sales contract (See Note 8.) | 70,350 | 79,848 |
| Notes and interest receivable | | |
| Performing (including \$40,496 in 2004 and \$18,793 in 2003 from affiliates and related parties) | 56,630 | 27,894 |
| Non-performing, non-accruing | | 4,303 |
| | <u>56,630</u> | <u>32,197</u> |
| Less allowance for estimated losses | | (1,456) |
| | <u>56,630</u> | <u>30,741</u> |
| Investment in real estate entities | 17,582 | 14,271 |
| Marketable equity securities, at market value | 6,580 | 5,000 |
| Cash and cash equivalents | 21,845 | 6,434 |
| Other assets (including \$14,125 in 2004 and \$4,819 in 2003 from affiliates and related parties) | 39,146 | 44,011 |
| | <u>\$ 920,311</u> | <u>\$ 882,784</u> |
| Liabilities and Stockholders Equity | | |
| Liabilities: | | |
| Notes and interest payable | \$ 524,670 | \$ 540,768 |
| Liabilities related to assets held for sale | 59,424 | 18,225 |
| Liabilities subject to sales contract (See Note 8.) | 59,977 | 67,472 |
| Other liabilities (including \$2,282 in 2004 and \$607 in 2003 to affiliates and related parties) | 34,840 | 34,687 |
| | <u>678,911</u> | <u>661,152</u> |
| Commitments and contingencies | | |
| Minority interest | 881 | (126) |
| Stockholders equity: | | |
| Preferred Stock | | |
| Series C; \$.01 par value; authorized, issued and outstanding 30,000 shares; (liquidation preference \$3,000) | | |
| Common Stock, \$.01 par value; authorized, 10,000,000 shares; issued and outstanding 7,900,869 in 2004 and 8,113,669 shares in 2003 | 81 | 81 |

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| | | |
|--|-------------------|-------------------|
| Paid-in capital | 256,704 | 256,914 |
| Treasury stock | (3,086) | |
| Accumulated deficit | (10,915) | (34,621) |
| Accumulated other comprehensive income | (2,265) | (616) |
| | <u>240,519</u> | <u>221,758</u> |
| | <u>\$ 920,311</u> | <u>\$ 882,784</u> |

The accompanying notes are an integral part of these Consolidated Financial Statements.

Table of Contents**Index to Financial Statements****TRANSCONTINENTAL REALTY INVESTORS, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS**

| | For the Years Ended December 31, | | |
|---|---|-----------------|-----------------|
| | 2004 | 2003 | 2002 |
| | As Restated (dollars in thousands, except per share) | | |
| Property revenue: | | | |
| Rents (including \$69 in 2004 and \$175 in 2003 from affiliates) | \$ 92,959 | \$ 77,801 | \$ 61,750 |
| Property operations (including \$4,849 in 2004 and \$4,546 in 2003 to affiliates) | 59,177 | 55,762 | 45,911 |
| Operating income | 33,782 | 22,039 | 15,839 |
| Land Operations: | | | |
| Sales | 32,550 | 11,807 | 3,600 |
| Cost of Sales | 24,859 | 8,450 | 2,934 |
| Deferred Gain on Sale | 581 | 1,716 | |
| Gain on Sales | 7,110 | 1,641 | 666 |
| Other income: | | | |
| Interest and other income (including \$2,069 in 2004 and \$1,459 in 2003 from affiliates) | 3,683 | 6,683 | 4,131 |
| Equity in loss of equity investees | (1,497) | (4,291) | (3,818) |
| Gain on settlement of debt | | 4,392 | |
| Gain on condemnation award | | 4,800 | |
| Gain on foreign currency transaction | 3,766 | | |
| Dividends received | 555 | | |
| | 6,507 | 11,584 | 313 |
| Other expense: | | | |
| Interest (including \$379 in 2004 to affiliates) | 32,433 | 23,657 | 20,383 |
| Depreciation | 17,700 | 13,173 | 11,626 |
| Provision for asset impairment | 1,722 | 198 | 2,579 |
| Provision for losses | (1,456) | 158 | 169 |
| Discount on sale of note receivables | | 104 | |
| Advisory fees | 6,733 | 4,935 | 4,465 |
| Net income fee | 1,933 | | 374 |
| General and administrative (including \$2,181 in 2004 and \$1,630 in 2003 to affiliates) | 9,312 | 9,149 | 8,774 |
| Loss on foreign currency transactions | | 3,309 | 2,455 |
| Minority interest | 1,194 | (2,230) | (893) |
| Total Other expenses | 69,571 | 52,453 | 49,932 |
| Net loss from continuing operations before taxes | (22,172) | (17,189) | (33,114) |
| Income tax benefit | 10,976 | | |
| Net loss from continuing operations | (11,196) | (17,189) | (33,114) |

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| | | | |
|---|-----------|--------|----------|
| Discontinued Operations (Note 19): | 58,378 | 17,862 | 37,965 |
| Less: Income tax expense | (23,476) | | |
| Net income from discontinued operations | 34,902 | 17,862 | 37,965 |
| Net income | 23,706 | 673 | 4,851 |
| Preferred dividend requirement | (210) | (126) | (190) |
| Net income applicable to Common shares | \$ 23,496 | \$ 547 | \$ 4,661 |

The accompanying notes are an integral part of these Consolidated Financial Statements.

Table of Contents**Index to Financial Statements****TRANSCONTINENTAL REALTY INVESTORS, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS (Continued)**

| | For the Years Ended December 31, | | |
|---|---|--------------------|---------------|
| | 2004 | 2003 | 2002 |
| | | As Restated | |
| Basic earnings per share: | | | |
| Net loss from continuing operations | \$ (1.41) | \$ (2.36) | \$ (4.12) |
| Correction of accounting error in prior period (See Note 21.) | | .22 | |
| Discontinued operations | 4.31 | 2.21 | 4.70 |
| Net income applicable to Common shares | \$ 2.90 | \$.07 | \$.58 |
| Diluted earnings: | | | |
| Net loss from continuing operations | \$ (1.41) | \$ (2.36) | \$ (4.12) |
| Correction of accounting error in prior period (See Note 21.) | | .22 | |
| Discontinued operations | 4.31 | 2.21 | 4.70 |
| Net income applicable to Common shares | \$ 2.90 | \$.07 | \$.58 |
| Weighted average Common shares used in computing earnings per share: | | | |
| Basic | 8,082,854 | 8,078,108 | 8,057,361 |
| Diluted | 8,082,854 | 8,078,108 | 8,057,361 |

The accompanying notes are an integral part of these Consolidated Financial Statements.

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TRANSCONTINENTAL REALTY INVESTORS, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

| | Common Stock | | Treasury Stock | Paid-in Capital | Accumulated Deficit | Accumulated | Stockholders Equity |
|--|---------------------------------------|--------|-------------------|--------------------|------------------------|----------------------------------|------------------------|
| | Shares | Amount | | | | Other Comprehensive Income | |
| | (dollars in thousands, except shares) | | | | | | |
| Balance, January 1, 2002 | 8,042,594 | \$ 80 | \$ | \$ 256,833 | \$ (40,145) | \$ | \$ 216,768 |
| Comprehensive income | | | | | | | |
| Unrealized (loss) on foreign currency translation | | | | | | 567 | 567 |
| Net income | | | | | 4,851 | | 4,851 |
| | | | | | | | 5,418 |
| Issuance of Common Stock upon exercise of stock options | 30,000 | 1 | | 397 | | | 398 |
| Series A Preferred Stock cash dividends (\$5.00 per share) | | | | (29) | | | (29) |
| Series C Preferred Stock cash dividends (\$5.00 per share) | | | | (161) | | | (161) |
| Balance, December 31, 2002 | 8,072,594 | 81 | | 257,040 | (35,294) | 567 | 222,394 |
| Comprehensive income | | | | | | | |
| Unrealized (loss) on foreign currency translation | | | | | | (1,183) | (1,183) |
| Net income (As Restated) | | | | | 673 | | 673 |
| | | | | | | | (510) |
| Series A Preferred Stock cash dividends (\$5.00 per share) | | | | (29) | | | (29) |
| Series C Preferred Stock cash dividends (\$6.00 per share) | | | | (97) | | | (97) |
| Conversion of 5,829 Series A Preferred Stock into Common Stock | 41,075 | | | | | | |
| Balance, December 31, 2003 (As Restated) | 8,113,669 | 81 | | 256,914 | (34,621) | (616) | 221,758 |
| Comprehensive income | | | | | | | |
| Unrealized loss on foreign currency translation | | | | | | (3,229) | (3,229) |
| Unrealized gain on marketable securities | | | | | | 1,580 | 1,580 |
| Net income | | | | | 23,706 | | 23,706 |

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| | | | | | | | |
|---|------------------|--------------|-------------------|-------------------|--------------------|-------------------|-------------------|
| | | | | | | | 22,057 |
| Repurchase of common stock | (212,800) | | (3,086) | | | | (3,086) |
| Series C Preferred Stock cash dividends (\$7.00 per share) | | | | (210) | | | (210) |
| Balance, December 31, 2004 | <u>7,900,869</u> | <u>\$ 81</u> | <u>\$ (3,086)</u> | <u>\$ 256,704</u> | <u>\$ (10,915)</u> | <u>\$ (2,265)</u> | <u>\$ 240,519</u> |

The accompanying notes are an integral part of these Consolidated Financial Statements.

Table of Contents**Index to Financial Statements****TRANSCONTINENTAL REALTY INVESTORS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

| | For the Years Ended December 31, | | |
|---|---|-------------------------------|-------------|
| | 2004 | 2003 | 2002 |
| | | As Restated | |
| | | (dollars in thousands) | |
| Cash Flows from Operating Activities: | | | |
| Reconciliation of net loss to net cash used by operating activities | | | |
| Net Income | \$ 23,706 | \$ 673 | \$ 4,851 |
| Adjustments to reconcile net loss to net cash provided by <used in> operating activities: | | | |
| Depreciation and amortization | 22,578 | 20,860 | 20,666 |
| Provision for loss | (1,456) | 104 | 169 |
| Amortization of deferred borrowing costs | 3,900 | 3,134 | 3,253 |
| Gain on sale of real estate | (74,342) | (28,144) | (43,958) |
| Provision for asset impairment | 6,199 | 4,713 | 2,579 |
| Equity in loss of equity investees | 1,497 | 4,291 | 3,818 |
| Gain on settlement of debt | | (4,392) | |
| Gain on condemnation award | | (4,800) | |
| Loss on foreign currency transaction | | 3,309 | 2,455 |
| Gain on foreign currency transaction | (3,766) | | |
| <Gain>loss allocated to minority interest | 1,194 | (2,230) | (893) |
| Increase in interest receivable | (1,209) | (683) | (665) |
| <Increase> decrease in other assets | 9,173 | 1,670 | (4,940) |
| Increase <decrease> in interest payable | (889) | 311 | 1,397 |
| Increase in other liabilities | 195 | 4,954 | 2,156 |
| Net cash provided by <used in> operating activities | (13,220) | 3,770 | (9,112) |
| Cash Flows from Investing Activities: | | | |
| Collections on notes receivable (including \$718 in 2004 and \$1,241 in 2003 from affiliates) | 8,851 | 4,651 | 16,193 |
| Funding of notes receivable (including \$3,297 in 2004 from affiliates) | (3,457) | (736) | (18,337) |
| Acquisitions of real estate | (40,140) | (14,250) | (12,688) |
| Real estate improvements | (9,328) | (4,462) | (7,001) |
| Real estate construction (including \$5,625 in 2004 and \$4,050 in 2003 to affiliates) | (152,684) | (59,055) | (104,235) |
| Proceeds from sale of real estate | 221,497 | 56,635 | 106,085 |
| Payments made under interest rate swap agreement | | (87) | (272) |
| Purchase of marketable equity securities | | (5,000) | |
| Deposits on pending purchase | (4,825) | (9,784) | (716) |
| Payments (to) from advisor | (39,867) | 5,264 | (39,739) |
| Net advance to affiliates | | | (6,232) |
| Distributions <contributions> to equity investees | 1,007 | (48) | (15) |
| Net cash used in investing activities | (18,946) | (26,872) | (66,957) |
| Cash Flows from Financing Activities: | | | |
| Payments on notes payable (including \$226 in 2004 to affiliates) | (276,137) | (124,659) | (95,731) |

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| | | | |
|--|-------------------|-------------------|-------------------|
| Proceeds from notes payable | 330,988 | 146,072 | 176,069 |
| Payments to minority interests | | | (704) |
| Dividends paid | | | (104) |
| Dividends paid to preferred shareholders | (263) | (74) | |
| Repurchase of Common Stock | (3,086) | | |
| Deferred financing costs | (3,925) | (2,361) | (3,647) |
| Proceeds from exercise of stock options | | | 398 |
| | <u> </u> | <u> </u> | <u> </u> |
| Net cash provided by financing activities | 47,577 | 18,978 | 76,281 |
| | <u> </u> | <u> </u> | <u> </u> |
| Net increase (decrease) in cash and cash equivalents | 15,411 | (4,124) | 212 |
| Cash and cash equivalents, beginning of year | 6,434 | 10,558 | 10,346 |
| | <u> </u> | <u> </u> | <u> </u> |
| Cash and cash equivalents, end of year | \$ 21,845 | \$ 6,434 | \$ 10,558 |
| | <u> </u> | <u> </u> | <u> </u> |

The accompanying notes are an integral part of these Consolidated Financial Statements.

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TRANSCONTINENTAL REALTY INVESTORS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

| | For the Years Ended December 31, | | |
|---|----------------------------------|-----------|-----------|
| | 2004 | 2003 | 2002 |
| | (dollars in thousands) | | |
| Supplemental Disclosures of Cash Flow Information: | | | |
| Cash paid for interest | \$ 39,210 | \$ 43,016 | \$ 41,379 |
| Notes payable assumed on purchase of real estate | 15,033 | 2,650 | 63,555 |
| Notes payable assumed by buyer on sale of real estate | 21,898 | 11,291 | 12,110 |
| Funds collected by affiliate on sale of note receivable | | 2,633 | |
| Notes receivable received from sale of real estate | 21,608 | 4,760 | 6,700 |
| Real estate refinancing proceeds received by affiliate | | 1,226 | |
| Real estate received on exchange with related party | | | 4,145 |
| Real estate received from related party to satisfy debt | 36,198 | 10,700 | 46,200 |
| Real estate sold to a related party to satisfy debt | 5,000 | | |
| Note payable proceeds used by affiliate for purchase of real estate | 1,000 | | |
| Note payable proceeds used by affiliate to satisfy debt | 1,260 | | |
| Note payable paid-off on behalf of affiliate | 1,851 | | |
| Notes receivable payments received by affiliate and added to affiliate receivable balance | | | 2,544 |
| Asset impairment write-down | 6,199 | | |
| Issuance of note payable for which cash proceeds were received by the advisor | | 6,239 | 4,000 |

The accompanying notes are an integral part of these Consolidated Financial Statements.

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TRANSCONTINENTAL REALTY INVESTORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The accompanying Consolidated Financial Statements of Transcontinental Realty Investors, Inc. and consolidated entities have been prepared in conformity with accounting principles generally accepted in the United States of America, the most significant of which are described in NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES. The Notes to Consolidated Financial Statements are an integral part of the Consolidated Financial Statements. The data presented in the Notes to Consolidated Financial Statements are as of December 31 of each year and for the year then ended, unless otherwise indicated. Dollar amounts in tables are in thousands, except per share amounts.

Effective March 31, 2003, TCI financial results have been consolidated in the American Realty Investors, Inc. (ARI) Form 10-K and related consolidated financial statements. As of December 31, 2004, ARI owned 82.2% of the outstanding TCI common shares.

Certain balances for 2003 and 2002 have been reclassified to conform to the 2004 presentation.

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization and business. Transcontinental Realty Investors, Inc. (TCI), a Nevada corporation, is successor to a California business trust which was organized on September 6, 1983, and commenced operations on January 31, 1984. TCI invests in real estate through direct ownership, leases and partnerships and it also invests in mortgage loans on real estate. In October 2001, TCI announced a preliminary agreement for the acquisition of TCI by American Realty Investors, Inc. (ARI). See NOTE 22. COMMITMENTS AND CONTINGENCIES AND LIQUIDITY.

Basis of consolidation. The Consolidated Financial Statements include the accounts of TCI and controlled subsidiaries and partnerships. All significant intercompany transactions and balances have been eliminated.

Accounting estimates. In the preparation of Consolidated Financial Statements in conformity with accounting principles generally accepted in the United States of America, it is necessary for management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the Consolidated Financial Statements and the reported amounts of revenues and expense for the year ended. Actual results could differ from those estimates.

Interest recognition on notes receivable. It is TCI's policy to cease recognizing interest income on notes receivable that have been delinquent for 60 days or more. In addition, accrued but unpaid interest income is only recognized to the extent that the net realizable value of the underlying collateral exceeds the carrying value of the receivable.

Allowance for estimated losses. Valuation allowances are provided for estimated losses on notes receivable considered to be impaired. Impairment is considered to exist when it is probable that all amounts due under the terms of the note will not be collected. Valuation allowances are provided for estimated losses on notes receivable to the extent that the Company's investment in the note exceeds the estimated fair value of the collateral securing such note.

Recent Accounting pronouncements. SFAS No. 151 In November 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 151, Inventory Costs, an Amendment of ARB No. 43, Chapter 4 (SFAS No. 151). SFAS No. 151 amends ARB 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) be recognized as current period charges. It also requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs

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TRANSCONTINENTAL REALTY INVESTORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS No. 151 is not expected to have a material impact on the consolidated financial position or results of operations of TCI.

SFAS No. 152 In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 152, Accounting for Real Estate Time-Sharing Transactions (SFAS No. 152). SFAS No. 152 amends FASB Statement No. 66, Accounting for Sales of Real Estate, to reference the financial accounting and reporting guidance for real estate time-sharing transactions that is provided in AICPA Statement of Position 04-2, Accounting for Real Estate Time-Sharing Transactions (SOP 04-2). This Statement also amends FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects, to state that the guidance for (a) incidental operations and (b) costs incurred to sell real estate projects does not apply to real estate time-sharing transactions. The accounting for those operations and costs is subject to the guidance in SOP 04-2.

SFAS No. 152 is effective for financial statements for fiscal years beginning after June 15, 2005, and is to be reported as a cumulative effect of a change in accounting principle. The adoption of SFAS No. 145 is not expected to have a material impact on the consolidated financial position or results of operations of TCI.

SFAS No. 123 In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123, Share-Based Payment, revised (SFAS No. 123R). SFAS No. 123R addresses the accounting for share-based payments to employees, including grants of employee stock options. Under the new standard, companies will no longer be able to account for share-based compensation transactions using the intrinsic method in accordance with APB Opinion No. 25, Accounting for Stock Issued to Employees. Instead, companies will be required to account for such transactions using a fair-value method and recognize the expense in the consolidated statement of income. SFAS No. 123R will be effective for periods beginning after June 15, 2005 and allows, but does not require, companies to restate the full fiscal year of 2005 to reflect the impact of expensing share-based payments under SFAS No. 123R. The Company has not yet determined which fair-value method and transitional provision it will follow. The adoption of SFAS No. 123R is not expected to have a material impact on the Company's consolidated financial position or results of operations. See Stock-Based Employee Compensation for the pro forma impact on net income and net income per share from calculating stock-based compensation costs under the fair value alternative of SFAS No. 123.

SFAS No. 153 In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 153, Exchanges of Non-monetary Assets, An Amendment of APB Opinion No. 29 (SFAS No. 153). The guidance in APB Opinion No. 29, Accounting for Non-monetary Transactions, is based on the principle that exchanges of non-monetary assets should be measured based on the fair value of the assets exchanged. The guidance in APB Opinion No. 29, however, included certain exceptions to that principle. SFAS No. 153 amends APB Opinion No. 29 to eliminate the exception for non-monetary exchanges of similar productive assets and replaces it with a general exception for exchanges of non-monetary assets that do not have commercial substance. A non-monetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for non-monetary asset exchanges in fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 is not expected to have a material impact on the consolidated financial position or results of operations of TCI.

Real estate held for investment and depreciation. Real estate held for investment is carried at cost. Statement of Financial Accounting Standards No. 144 (SFAS No. 144) requires that a property be considered impaired, if the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the property. If impairment exists, an impairment loss is recognized, by a charge against earnings, equal to the amount by which the carrying amount of the property exceeds the fair value of the property. If impairment of a property is recognized, the carrying amount of the property is reduced by the amount

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TRANSCONTINENTAL REALTY INVESTORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

of the impairment, and a new cost for the property is established. Such new cost is depreciated over the property's remaining useful life. Depreciation is provided by the straight-line method over estimated useful lives, which range from five to 40 years.

Real estate held for sale. Foreclosed real estate is initially recorded at new cost, defined as the lower of original cost or fair value minus estimated cost of sale. SFAS No. 144 also requires properties held for sale be reported at the lower of carrying amount or fair value less costs of sale. If a reduction in a held for sale property's carrying amount to fair value less costs of sale is required, a provision for loss is recognized by a charge against earnings. Subsequent revisions, either upward or downward, to a held for sale property's estimated fair value less costs of sale is recorded as an adjustment to the property's carrying amount, but not in excess of the property's carrying amount when originally classified as held for sale. A corresponding charge against or credit to earnings is recognized. Properties held for sale are not depreciated.

Foreign Currency Translation. Foreign currency denominated assets and liabilities of subsidiaries with local functional currencies are translated to United States dollars at year-end exchange rates. The effects of translation are recorded in the accumulated other comprehensive income component of shareholders' equity. Subsidiaries with a United States dollar functional currency remeasure monetary assets and liabilities at year-end exchange rates and non-monetary assets and liabilities at historical exchange rates. The effects of remeasurement are included in income. Exchange gains and losses arising from transactions denominated in foreign currencies are translated at average exchange rates. The effects of these exchange adjustments resulted in gains of \$3.8 million in 2004 and losses of \$3.3 million in 2003.

Revenue recognition on the sale of real estate. Sales of real estate are recognized when and to the extent permitted by Statement of Financial Accounting Standards No. 66, *Accounting for Sales of Real Estate* (SFAS No. 66), as amended by SFAS No. 144. Until the requirements of SFAS No. 66 for full profit recognition have been met, transactions are accounted for using either the deposit, installment, cost recovery or the financing method, whichever is appropriate.

Investment in noncontrolled equity investees. The equity method is used to account for investments in partnerships which TCI does not control but for which significant influence can be exerted, and for its investment in the shares of common stock of Income Opportunity Realty Investors, Inc., (IORI) and ARI. Under the equity method, an initial investment, recorded at cost, is increased by a proportionate share of the investee's operating income and any additional advances and decreased by a proportionate share of the investee's operating losses and distributions received.

Operating segments. Management has determined reportable operating segments to be those that are used for internal reporting purposes, which disaggregates operations by type of real estate.

Fair value of financial instruments. The following assumptions were used in estimating the fair value of notes receivable and notes payable. For performing notes receivable, the fair value was estimated by discounting future cash flows using current interest rates for similar loans. For non-performing notes receivable, the estimated fair value of TCI's interest in the collateral property was used. For notes payable, the fair value

was estimated using current rates for mortgages with similar terms and maturities.

Cash equivalents. For purposes of the Consolidated Statements of Cash Flows, all highly liquid investments purchased with an original maturity of three months or less are considered to be cash equivalents.

Earnings per share. Income (loss) per share is presented in accordance with Statement of Financial Accounting Standards No. 128, Earnings Per Share. Income (loss) per share is computed based upon the

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TRANSCONTINENTAL REALTY INVESTORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

weighted average number of shares of Common Stock outstanding during each year. Diluted net income per share is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the year. Dilutive common equivalent shares consist of stock options and convertible preferred stock. The weighted average common shares used to calculate diluted earnings per share for the years ended December 31, 2004, 2003 and 2002 exclude 264,874, 266,686 and 223,784 shares relating to options and convertible preferred stock to purchase shares of common stock. These dilutive shares were excluded from the calculation of dilutive earnings per share because the effect of their inclusion would be antidilutive.

Stock-based employee compensation. TCI accounts for stock-based compensation utilizing the intrinsic value method in accordance with the provisions of Accounting Principles Board Opinion No. 25 (APB 25), Accounting for Stock Issued to Employees, and related interpretations. Accordingly, no compensation expense is recognized for fixed option plans because the exercise prices of employee stock options equal or exceed the market prices of the underlying stock on the dates of grant.

The following table represents the effect on net income and earnings per share if TCI had applied the fair value based method and recognition provisions of Statement of Financial Accounting Standards No. 123 (SFAS No. 123), Accounting for Stock-Based Compensation, to stock-based employee compensation:

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|--|---------------------------|---------------|-----------------|
| | (dollars in thousands, | | |
| | except per share amounts) | | |
| Net income (loss) applicable to common shares, as reported | \$ 23,496 | \$ 547 | \$ 4,661 |
| Deduct: Stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects | (137) | (109) | (105) |
| Proforma net income applicable to common shares | <u>\$ 23,359</u> | <u>\$ 438</u> | <u>\$ 4,556</u> |
| Net income (loss) per share: | | | |
| Basic, as reported | \$ 2.90 | \$.07 | \$.58 |
| Basic, pro forma | \$ 2.88 | \$.05 | \$.57 |
| Diluted, as reported | \$ 2.90 | \$.07 | \$.58 |
| Diluted, pro forma | \$ 2.88 | \$.05 | \$.57 |

The fair value of each option is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

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| | <u>2004</u> | <u>2003</u> |
|---------------------------|-------------|-------------|
| Dividend yield | | |
| Expected volatility | 35.10% | 33.45% |
| Risk-free interest rate | 4.04% | 4.04% |
| Expected lives (in years) | 9.0 | 9.0 |

The weighted average fair value per share of options granted in 2004 and 2003 was \$11.21 and \$11.82, respectively.

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In 2004, TCI purchased the following properties:

| Property | Location | Units/ Sq. Ft./Acres | Purchase Price | Net | | Interest Rate | Maturity Date |
|--|--------------------|-------------------------|-------------------|--------------------------|-----------------------|------------------|------------------|
| | | | | Cash Paid/ (Received) | Debt Incurred | | |
| Apartments | | | | | | | |
| 288 City Park ⁽¹⁾ | Houston, TX | 240 Units | \$ 3,056 | \$ 612 | \$ 2,444 | 5.95% | 04/45 |
| Blue Lake Villas II ⁽¹⁾ | Waxahachie, TX | 70 Units | 729 | (164) | 729 | 5.80 | 04/45 |
| Bridges on Kinsey ⁽¹⁾ | Tyler, TX | 232 Units | 2,291 | 596 | 1,687 | 5.74 | 08/45 |
| Dakota Arms ⁽¹⁾ | Lubbock, TX | 208 Units | 2,472 | 681 | 1,791 | 5.85 | 06/45 |
| Laguna Vista ⁽¹⁾ | Farmers Branch, TX | 206 Units | 2,424 | 902 | 1,522 | 5.50 | 09/46 |
| Lake Forest ⁽¹⁾ | Houston, TX | 240 Units | 2,316 | (470) | 2,316 | 5.60 | 03/45 |
| Parc at Maumelle ⁽¹⁾ | Maumelle, AR | 240 Units | 3,120 | 916 | 2,204 | 5.37 | 07/46 |
| Treehouse ⁽²⁾ | Irving, TX | 160 Units | 7,519 | (498) | 5,027 ⁽³⁾ | 5.00 | 08/13 |
| Vistas of Vance Jackson ⁽¹⁾ | San Antonio, TX | 240 Units | 3,550 | 771 | 2,779 | 5.78 | 06/45 |
| Wildflower Villas ⁽¹⁾ | Temple, TX | 220 Units | 2,045 | 79 | 1,966 | 5.99 | 10/45 |
| Commercial | | | | | | | |
| Executive Court ⁽⁴⁾ | Memphis, TN | 41,840 Sq. Ft. | 1,970 | | | | |
| Land | | | | | | | |
| Cooks Lane land | Ft. Worth, TX | 23.242 Acres | 1,000 | 1,034 | | | |
| Denton-Coonrod land | Denton, TX | 82.203 Acres | 1,644 | 1,046 | 840 | 6.25 | 11/06 |
| DeSoto land | DeSoto, TX | 21.897 Acres | 2,516 | 1,364 | 1,265 | 6.25 | 11/06 |
| Granbury Station land | Ft. Worth, TX | 15.696 Acres | 923 | 236 | 738 | 7.00 | 09/07 |
| Lacy Longhorn land ⁽⁵⁾ | Farmers Branch, TX | 17.115 Acres | 4,474 | | | | |
| Los Colinas land ⁽⁶⁾ | Los Colinas, TX | 239.2 Acres | 39,145 | | 10,006 ⁽⁷⁾ | (7) | (7) |
| Lubbock land | Lubbock, TX | 2.866 Acres | 224 | 224 | | | |
| Railroad land | Dallas, TX | .293 Acres | 708 | 704 | | | |
| Rogers land | Rogers, AR | 20.08 Acres | 1,390 | 619 | 1,130 | 10.50 | 04/05 |
| Vista Ridge land ⁽⁸⁾ | Lewisville, TX | 14.216 Acres | 2,585 | | | | |
| West End land ⁽⁹⁾ | Dallas, TX | .158 Acres | 71 | 71 | | | |

(1) Initial construction loan funding to purchase land and begin apartment construction. Does not represent actual units purchased.

(2) Purchased from IORI, a related party, for assumption of debt and a note receivable, less \$498,000 in cash received.

(3) Assumed debt.

(4) Property received from ARI, a related party, for payment of a note receivable. See NOTE 3. NOTES AND INTEREST RECEIVABLE.

(5) Property received from ARI, a related party, for a decrease of \$4.5 million to TCI's affiliate receivable with Prime.

(6) The following tracts of land were purchased from ARI, a related party, for a decrease of \$29.1 million to TCI's affiliate receivable from Prime: Payne, LCLLP, Rochelle I & II and Valley Ranch. TCI owns a 50% Tenant-in-Common interest in the 268 acre Payne tract.

(7)

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Includes \$3.1 million assumed debt on the LCLLP tract with an interest rate of 7.0% and a maturity date of 12/06 and \$6.9 million assumed debt on the Rochelle I & II and Valley Ranch tracts with an interest rate of prime plus 3% (currently 8.75%) and a maturity date of 11/05.

- (8) Property received from ARI, a related party, for a decrease of \$2.6 million to TCI's affiliate receivable from Prime.
- (9) TCI purchased a 50% interest in this land tract.

Table of Contents**Index to Financial Statements****TRANSCONTINENTAL REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In 2003, TCI purchased the following properties:

| Property | Location | Units/ Sq. Ft./Acres | Purchase Price | Net Cash Paid | Debt Incurred | Interest Rate | Maturity Date |
|---------------------------------|--------------------|---------------------------------|---------------------------|--------------------------|--------------------------|--------------------------|--------------------------|
| Apartments | | | | | | | |
| Breakwater Bay ⁽¹⁾ | Beaumont, TX | 176 Units | \$ 1,979 | \$ 383 | \$ 1,554 | 5.65% | 08/44 |
| Capitol Hill ⁽¹⁾ | Little Rock, AR | 156 Units | 1,904 | 615 | 1,289 | 5.65 | 10/44 |
| Heather Creek ⁽¹⁾ | Mesquite, TX | 200 Units | 2,523 | 449 | 2,074 | 5.90 | 06/44 |
| Kingsland Ranch ⁽¹⁾ | Houston, TX | 398 Units | 3,300 | | 3,300 | 6.12 | 03/45 |
| Windsong | Fort Worth, TX | 188 Units | 11,939 | 1,194 | 10,745 | 7.20 | 10/43 |
| Shopping Center | | | | | | | |
| Bridgeview Plaza ⁽²⁾ | LaCrosse, WI | 116,008 Sq. Ft. | 8,700 | | | | |
| Cullman ⁽²⁾ | Cullman, AL | 92,433 Sq. Ft. | 2,000 | | 2,650 ⁽⁴⁾ | 16.75 | 3/03 ⁽³⁾ |
| Land | | | | | | | |
| Maumelle | Maumelle, AR | 10.8 Acres | 1,100 | 412 | 640 | 5.75 | 07/04 |
| Pulaski | Pulaski County, AR | 21.9 Acres | 2,000 | 695 | 1,400 | 6.50 | 05/05 |
| Sheffield Village | Grand Prairie, TX | 13.899 Acres | 1,500 | 464 | 975 | 5.50 ⁽⁵⁾ | 09/04 |

(1) Initial construction loan funding to purchase land and begin apartment construction. Does not represent actual units purchased.

(2) Property received from a related party for a reduction in TCI's affiliate receivable.

(3) Debt was paid off in April refinance. See NOTE 7. NOTES AND INTEREST PAYABLE.

(4) Assumed debt.

(5) Variable interest rate.

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In 2004, TCI sold the following properties:

| Property | Location | Units/ Sq. Ft./Acres | Sales Price | Net Cash Received | Debt Discharged | Gain/ (Loss) on Sale |
|---|--------------------|---------------------------------|------------------------|------------------------------|----------------------------|-------------------------------------|
| Apartments | | | | | | |
| Cliffs of El Dorado ⁽²⁾ | McKinney, TX | 208 Units | \$ 13,442 | \$ 10 | \$ 10,323 ⁽¹⁾ | \$ (3) |
| In The Pines | Gainesville, FL | 242 Units | 11,300 | 3,547 ⁽⁴⁾ | 5,201 | 5,136 |
| Sandstone | Mesa, AZ | 238 Units | 8,650 | 2,687 | 5,531 | 1,136 |
| Waters Edge IV ⁽⁵⁾ | Gulfport, MS | 80 Units | 5,000 | | | ⁽⁶⁾ |
| Office Building | | | | | | |
| 4135 Beltline | Addison, TX | 90,000 Sq. Ft. | 4,900 | 2,472 | 2,009 | 345 |
| Atrium | Palm Beach, FL | 74,603 Sq. Ft. | 5,775 | 1,667 | 3,772 | 328 |
| Ambulatory Surgery Center | Sterling, VA | 33,832 Sq. Ft. | 8,675 | 5,448 | 2,856 | 202 |
| Brandeis ⁽⁷⁾ | Omaha, NE | 319,234 Sq. Ft. | | | 8,750 ⁽¹⁾ | (92) |
| Centura Tower ⁽⁸⁾ | Farmers Branch, TX | 410,901 Sq. Ft. | 84,075 | 36,350 | 49,878 | 31,550 |
| Corporate Pointe | Chantilly, VA | 69,918 Sq. Ft. | 9,000 | 5,025 | 3,609 | 5,239 |
| Countryside Harmon | Sterling, VA | 72,062 Sq. Ft. | 9,150 | 4,608 | 3,865 | 1,931 |
| Countryside Retail | Sterling, VA | 133,422 Sq. Ft. | 27,100 | 3,408 | 22,800 | 6,236 |
| Countryside Mimado | Sterling, VA | 35,127 Sq. Ft. | 4,000 | 102 | 941 | 72 |
| Durham Centre ⁽⁹⁾ | Durham, NC | 207,171 Sq. Ft. | 21,300 | 6,703 | | ⁽¹⁰⁾ |
| One Steeplechase | Sterling, VA | 103,376 Sq. Ft. | 11,900 | 3,743 | 7,654 | 6,184 |
| Venture Center | Atlanta, GA | 38,272 Sq. Ft. | 4,000 | 997 | 2,550 | 1,167 |
| Industrial Warehouse | | | | | | |
| Kelly (Cash Road) | Dallas, TX | 97,150 Sq. Ft. | 1,500 | 1,077 | 422 | 127 |
| Kelly (Pinewood) | Dallas, TX | 100,000 Sq. Ft. | 1,650 | 65 | 1,376 | 153 |
| Ogden Industrial | Ogden, UT | 107,112 Sq. Ft. | 2,600 | 668 | 1,775 | 1,374 |
| Texstar Warehouse ⁽¹²⁾ | Arlington, TX | 97,846 Sq. Ft. | 2,400 | | 1,148 ⁽¹⁾⁽¹⁷⁾ | ⁽¹³⁾ |
| Other | | | | | | |
| Signature Athletic Club ⁽¹¹⁾ | Dallas, TX | N/A | \$ 120 | \$ (154) | \$ 88 | \$ (47) |
| Shopping Center | | | | | | |
| K-Mart ⁽¹²⁾ | Cary, NC | 92,033 Sq. Ft. | 3,200 | | 1,677 ⁽¹⁾⁽¹⁷⁾ | ⁽¹⁴⁾ |
| Sadler Square | Amelia Island, FL | 70,295 Sq. Ft. | 4,500 | 1,876 | 2,680 | 1,673 |
| Land | | | | | | |
| Allen | Collin County, TX | 492.531 Acres | 19,962 | 7,956 | 4,088 | 7,056 |
| Marine Creek ⁽¹⁵⁾ | Ft. Worth, TX | 10.73 Acres | 1,488 | 1,198 | 991 | ⁽¹⁶⁾ |
| Rasor | Plano, TX | 24.5 Acres | 2,600 | 2,600 | | 53 |
| Red Cross | Dallas, TX | 2.89 Acres | 8,500 | 2,842 | 4,450 | |

(1) Assumed debt.

(2) Property initially sold to Unified Housing Foundation, Inc. (UHF), a related party, in 2003. See NOTE 8. RELATED PARTY TRANSACTIONS.

(3) Excludes a \$1.7 million deferred gain from a related party sale.

(4) TCI provided \$1.0 million of the purchase price as seller financing. See NOTE 3. NOTES AND INTEREST RECEIVABLE.

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- (5) Property sold to ARI, a related party, for an increase of \$5.0 million to the affiliate receivable balance from Prime.
- (6) Excludes a \$494,000 deferred gain from a related party sale.
- (7) Brandeis was returned to lender via a deed in lieu of foreclosure process. See NOTE 7. NOTES AND INTEREST PAYABLE.
- (8) TCI sold a 95% limited partnership interest, retaining a 1% general partner and 4% limited partner interest.
- (9) Property sold to Edina Park Plaza Associates, L.P., of which the managing general partner is a subsidiary of ARI, a related party, for a wraparound note of \$14.5 million and cash.
- (10) Excludes a \$4.0 million deferred gain from a related party sale.

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- (11) Signature Athletic Club was sold for the assumption of capital leases by purchaser. Net cash paid is from prepaid dues and unearned revenues due purchaser.
- (12) Property sold to Basic Capital Management (BCM), a related party, for assumption of debt and a note receivable. See NOTE 3. NOTES AND INTEREST RECEIVABLE.
- (13) Excludes a \$1.0 million deferred gain from a related party sale.
- (14) Excludes \$355,000 deferred gain from a related party sale.
- (15) Property sold to UHF, a related party, for cash and a note receivable. See NOTE 8. RELATED PARTY TRANSACTIONS.
- (16) Excludes a \$581,000 deferred gain from a related party sale.
- (17) Failure to notify and receive approval from the lender for this transaction may constitute an event of default under the terms of the debt.

In 2003, TCI sold the following properties:

| Property | Location | Units/ Sq. Ft./Acres | Sales Price | Net Cash Received | Debt Discharged | Gain/ (Loss) on Sale |
|--|-------------------|---------------------------------|------------------------|------------------------------|----------------------------|-------------------------------------|
| Apartments | | | | | | |
| Lincoln Court | Dallas, TX | 55 Units | \$ 3,038 | \$ 1,834 | \$ 1,208 ⁽¹⁾ | \$ 1,654 |
| Quail Creek | Lawrence, KS | 96 Units | 4,700 | 1,188 | 3,260 | 1,358 |
| Stone Oak | San Antonio, TX | 252 Units | 6,930 | 3,670 | 2,699 | 4,193 |
| Summerfield | Orlando, FL | 224 Units | 9,415 | 4,845 | 4,476 | 3,684 |
| Treehouse ⁽⁵⁾ | Irving, TX | 160 Units | 7,500 | | 5,083 ⁽¹²⁾ | ⁽⁶⁾ |
| Willow Wick | North Augusta, NC | 104 Units | 2,707 | 255 | 1,943 | 999 |
| Office Building | | | | | | |
| Bonita Plaza | Bonita, CA | 47,777 Sq. Ft. | 8,034 | 1,647 | 5,944 | 2,139 |
| Remington Tower | Tulsa, OK | 90,009 Sq. Ft. | 3,360 | (80) | 3,360 ⁽¹⁾ | (1,056) |
| Industrial Warehouse | | | | | | |
| Kelly (301 Hilltop) | Dallas, TX | 76,946 Sq. Ft. | 1,800 | | 1,712 | 639 |
| Kelly (108th Street) | Dallas, TX | 20,871 Sq. Ft. | 675 | | 634 | 357 |
| McLeod | Orlando, FL | 110,914 Sq. Ft. | 5,450 | 2,980 | 1,902 | 2,490 |
| Tricon | Atlanta, GA | 570,877 Sq. Ft. | 13,084 | 3,364 | 9,395 | 4,587 |
| Shopping Center | | | | | | |
| K-Mart | Sheboygan, WI | 74,532 Sq. Ft. | 1,225 | 669 | 569 | 12 |
| Oak Tree Village | Lubbock, TX | 45,623 Sq. Ft. | 3,366 | ⁽⁴⁾ | 1,328 | 590 |
| Parkway Centre ⁽⁷⁾ | Dallas, TX | 28,374 Sq. Ft. | 4,000 | | 1,640 ⁽¹²⁾ | ⁽⁸⁾ |
| Land | | | | | | |
| Eagle Crest ⁽⁹⁾ | Dallas, TX | 19.99 Acres | 4,000 | | | ⁽¹⁰⁾ |
| Palm Desert | Palm Desert, CA | 25.06 Acres | 2,800 | ⁽³⁾ | | 617 |
| Sendero Ranch | Fort Worth, TX | 14 Acres | 300 | 292 | | (770) |
| Solco-Valley Ranch | Dallas, TX | 6.0693 Acres | 1,999 | ⁽²⁾ | | 384 |
| State Highway 121/Watters Road ⁽¹¹⁾ | Collin County, TX | 37.08 Acres | 2,188 | 1,197 | 912 | 1,410 |

(1) Assumed debt.

(2) Funds received by an affiliate increasing TCI's affiliate receivable balance by \$1,999.

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- (3) Funds received by an affiliate increasing TCI's affiliate receivable balance by \$2,600.
- (4) Funds received by an affiliate increasing TCI's affiliate receivable balance by \$1,640.
- (5) Property sold to IORI, a related party, for assumption of debt and reduction of \$2.4 million in affiliate receivables.
- (6) Excludes a \$4.4 million deferred gain from seller financing. See NOTE 3. NOTES AND INTEREST RECEIVABLE.
- (7) Property sold to IORI, a related party, for assumption of debt and reduction of \$2.3 million in affiliate receivables.

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- (8) Excludes a \$2.3 million deferred gain from seller financing. See NOTE 3. NOTES AND INTEREST RECEIVABLE.
- (9) Property sold to IORI, a related party, for a reduction in TCI's affiliate payable to IORI.
- (10) Excludes a \$1.7 million deferred gain from a related party sale. See NOTE 3. NOTES AND INTEREST RECEIVABLE.
- (11) Approximately 20 acres of Watters Road and 17.08 acres of State Highway 121 were sold together in a single transaction.
- (12) Failure to notify and receive approval from the lender for this transaction may constitute an event of default under the terms of the debt.

At December 31, 2004, TCI had the following properties under construction:

| Property | Location | Units | Amount Expended | Additional Amount to Expend | Construction Loan Funding |
|---|--------------------|--------------|----------------------------|--|--|
| Apartments | | | | | |
| Blue Lake Villas II | Waxahachie, TX | 76 Units | \$ 4,454 | \$ 217 | \$ 4,234 |
| Bluffs at Vista Ridge | Lewisville, TX | 272 Units | 17,239 | 3,347 | 15,500 |
| Bridges on Kinsey | Tyler, TX | 232 Units | 11,572 | 4,509 | 14,477 |
| Dakota Arms | Lubbock, TX | 208 Units | 12,611 | 1,326 | 12,549 |
| Kingsland Ranch | Houston, TX | 398 Units | 24,573 | 1,081 | 23,000 |
| Laguna Vista | Farmers Branch, TX | 206 Units | 3,432 | 17,673 | 17,741 |
| Lake Forest | Houston, TX | 240 Units | 13,919 | 519 | 12,815 |
| Parc at Maumelle | Maumelle, AR | 240 Units | 4,502 | 14,196 | 16,829 |
| Stonebridge at City Park (formerly 288 City Park) | Houston, TX | 240 Units | 15,486 | 1,201 | 15,005 |
| Vistas of Vance Jackson | San Antonio, TX | 240 Units | 13,393 | 4,708 | 16,056 |
| Wildflower Villas | Temple, TX | 220 Units | 9,377 | 6,220 | 14,073 |

For the period ending December 31, 2004, TCI completed the 248 unit DeSoto Ranch Apartments in DeSoto, Texas, the 314 unit Verandas at Cityview Apartments in Fort Worth, Texas, the 216 unit Mariposa Villas (Echo Valley) in Dallas, Texas, the 176 unit Breakwater Bay Apartments in Beaumont, Texas, the 156 unit Capitol Hill Apartments in Little Rock, Arkansas and the 332 unit Vistas of Pinnacle Park Apartments in Dallas, Texas.

In 2003, TCI completed 186 unit Blue Lake Villas in Waxahachie, Texas, the 284 unit Falcon Lakes in Arlington, Texas, the 180 unit River Oaks Apartments in Wiley, Texas, the 384 unit Sendero Ridge Apartments in San Antonio, Texas, the 256 unit Spyglass Apartments in Mansfield, Texas and the 188 unit Windsong Apartments in Fort Worth, Texas.

In November 2004, TCI agreed to swap 69,903 square feet of Centura land with 71,393 square feet of land TXU Electric Delivery Company (TXU) owns adjacent to Centura land for the relocation of electric transmission and distribution facilities. TCI has agreed to pay the actual costs of relocation, which is estimated at \$453,000. ARI paid \$216,361 of this cost on TCI's behalf in November 2004 and this amount was used to reduce TCI's receivable from Prime. TCI will also pay an additional \$36,000 to TXU for the difference in the size of the TCI property and the TXU property.

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TRANSCONTINENTAL REALTY INVESTORS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 3. NOTES AND INTEREST RECEIVABLE

Notes and interest receivable consisted of the following:

| | 2004 | | 2003 | |
|------------------------------|----------------------------|------------------|----------------------------|------------------|
| | Estimated Fair Value | Book Value | Estimated Fair Value | Book Value |
| Notes receivable | | | | |
| Performing | \$ 53,246 | \$ 53,895 | \$ 25,850 | \$ 26,368 |
| Non-performing, non-accruing | | | 4,303 | 4,303 |
| | <u>\$ 53,246</u> | <u>53,895</u> | <u>\$ 30,153</u> | <u>30,671</u> |
| Interest receivable | | 2,735 | | 1,526 |
| | | <u>\$ 56,630</u> | | <u>\$ 32,197</u> |

Notes receivable at December 31, 2004, mature from 2005 through 2017 with interest rates ranging from 4.0% to 12.0% per annum, with a weighted average rate of 8.47%. Notes receivable are generally non-recourse and are generally collateralized by real estate. Scheduled principal maturities of \$25.6 million are due in 2005.

Unless otherwise noted, all of TCI's notes receivables are secured by real estate assets.

In October 2004, TCI sold the In The Pines apartments to a third party and provided \$1.0 million of the purchase price as seller financing in the form of two notes. The first note bears interest at 7.0% per annum, requires monthly interest payments and matured in January 2005. The Purchaser extended this note to March 2005 by paying 1.0% of the outstanding principal balance as an extension fee and then extended the note an additional 30 days to April 2005 by paying an extension fee of 0.5% of the outstanding principal balance. In the event of a default, the note is also secured by membership rights in the purchaser's entity. The second note is unsecured, bears interest at 8.5% per annum, requires monthly interest payments and matured in January 2005. The Purchaser extended this note to March 2005 by paying 1.0% of the outstanding principal balance as an extension fee and then extended the note an additional 30 days to April 2005 by paying an extension fee of 0.5% of the outstanding principal balance.

In July 2003, TCI advanced \$2.3 million to the Class A Limited Partners of TCI Countryside, L.P. of which TCI is the general partner. This loan bears interest at 7.25% and matures in January 2007. TCI also agreed to advance \$1.1 million to the Class A Limited Partners by advancing \$105,000 in July 2003 and every year thereafter for ten years. This loan bears interest at 7.25% and matures in July 2012. Interest due to TCI will be deducted for the quarterly return owed by TCI to the Class A Limited Partners, eliminating the quarterly payments. After January 2007, TCI may retire the Class A Limited Partners interests in exchange for cancellation of both notes, subject to the \$1.1 million advance being fully advanced by TCI.

In June 2003, TCI sold the 104 unit Willo-Wick Gardens Apartments in North Augusta, South Carolina, for \$2.7 million and provided \$42,000 of the purchaser's closing costs as seller financing. The note bore interest at a fixed rate of 5.0% and required all interest and principal payments be paid at maturity on December 2003. This loan was extended until February 2004 and \$10,000 was received in March 2004. This note, including accrued but unpaid interest, was paid in June 2004. TCI discounted the note \$2,000 and recognized a loss of \$2,000.

In March 2002, TCI sold the 174,513 sq. ft. Hartford Office Building in Dallas, Texas, for \$4.0 million and provided the \$4.0 million purchase price as seller financing and an additional \$1.4 million line of credit for leasehold improvements in the form of a first lien mortgage note. The note bears interest at a variable interest

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

rate, currently 7.5% per annum, requires monthly interest only payments and matures in March 2007. As of March 2005, TCI has funded \$788,000 of the additional line of credit.

In July 2002, TCI entered into an agreement to fund up to \$300,000 under a revolving line of credit secured by 100% interest in a partnership of the borrower. The line of credit bears interest at 12.0% per annum and requires monthly interest only payments, and matures in June 2005. As of March 2005, TCI has funded \$300,000 of the line of credit.

In September 2002, TCI sold a 36 acre tract of the Palm Desert land parcel for \$3.6 million and provided \$2.7 million as seller financing in the form of a first lien mortgage note. The note bore interest at 8.0% per annum, required quarterly interest only payments of \$54,000 and matured in September 2004. In March 2003, the note was sold to a financial institution for \$2.6 million.

In August 2001, TCI agreed to fund up to \$5.6 million secured by a second lien on an office building in Dallas, Texas. The note receivable bore interest at a variable rate (then 9.0% per annum), required monthly interest only payments and originally matured in January 2003. As of March 2004, TCI had funded a total of \$4.3 million. On January 22, 2003, TCI agreed to extend the maturity date until May 1, 2003. The collateral used to secure TCI's second lien was seized by the first lien holder. On March 11, 2004, TCI agreed to accept an assignment of claims in litigation as additional security for the note. In December 2004, TCI agreed to a Modification Agreement with the borrower, which was effective November 1, 2003. As of the modified effective date, accrued interest of \$582,000 was added to the principal balance of the note, the interest rate fixed at 9.0% per annum and all principal and interest is due November 2005. TCI also received Pledge and Security Agreements in various partnership interests belonging to the borrower and received various Assignments of Proceeds from sales in certain entities owned by the borrower. TCI reduced accrued interest and principal by \$1.5 million from the receipt of notes receivable assigned to TCI by borrower and by \$605,000 from cash received. TCI also received \$1.4 million in January 2005 that was applied to accrued interest and principal effective December 30, 2004. As a result of this modification, TCI has released \$1.4 million of allowance for loan losses to expense. The following notes were assigned to TCI as payment on the note:

\$678,000 from a partnership that owns an apartment building. This note is unsecured, bears no interest and has no maturity date. Distributions made from the partnership operations will be used to pay the principal on the note.

\$264,000 secured by a second lien on 13 acres of unimproved land. This note bears interest at 9.0% and matured in February 2003. TCI's parent company, ARI, is in negotiations to take title to the collateral, therefore, this note is considered performing and no allowance has been established.

\$466,000 secured by a second lien on 23.3 acres of unimproved land. This note bears interest at 4.0% and is payable upon demand.

\$125,000 secured by a 100% interest in an affiliated company that owns an apartment building. This note bears interest at 12.0%, only requires payments if surplus cash is available and matures in April 2009.

Related Party. In October 2004, TCI contemplated the sale of the common stock of TCI Lexington Corporation, which owns the Lexington Center office building in Colorado Springs, Colorado, to One Realco Office Investors, Inc., a related party, for the assumption of debt of \$4.9 million, which was subject to lender approval, and a seller note of \$237,000. The assumption of debt by One Realco Office Investors, Inc. was not approved by the lender; therefore, TCI's Board of Directors rescinded their approval of the transaction. TCI extended the loan on the Lexington Center with the lender in December 2004.

In October 2004, TCI sold the Durham Centre in Durham, North Carolina to a partnership, of which the managing general partner is a subsidiary of ARI, for \$21.3 million for cash and an all-inclusive wraparound note of \$14.5 million. The note bears interest at a fixed rate of 7.63%, requires monthly interest payments and matures

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

in September 2007. TCI also made a loan to the partnership for \$3.3 million. The note bears interest at a fixed rate of 7.63%, requires monthly interest payments and matures in September 2017.

In March 2004, TCI sold a K-Mart in Cary, North Carolina to BCM for \$3.2 million, including the assumption of debt. TCI also provided \$1.5 million of the purchase price as seller financing. The unsecured note bears interest at the prime rate plus 2% (which is currently 7.75%), and matures in April 2005.

In March 2004, TCI sold the Texstar Warehouse in Arlington, Texas to BCM for \$2.4 million, including the assumption of debt. TCI also provided \$1.3 million of the purchase price as seller financing. The unsecured note bears interest at the prime rate plus 2% (which is currently 7.75%), and matures in April 2005.

In December 2003, TCI sold a tract of Marine Creek land to a subsidiary of United Housing Foundation, Inc. (UHF) for \$1.5 million, receiving cash and a note receivable. This sale was not recognized as a sale at that time because UHF is a related party and TCI has continuing involvement and control. In February 2004, Marine Creek was refinanced by UHF, which paid in full TCI's note payable on the land. TCI recorded the sale of the land and received a note receivable of \$270,000, which was the difference between the sales price and the amount of TCI's note payable. The note bears interest at 6.0%, requires quarterly payments from available surplus cash and matures in December 2007. See Note 8. RELATED PARTY TRANSACTIONS.

In December 2003, TCI purchased a note receivable secured by a second lien on 33 acres of raw land in Travis County, Texas at par value from ARI for \$2.4 million as a paydown on an affiliate loan balance. This note bears interest at 10.0%, requires interest only payments in November 2007 and matures in October 2008. Outstanding accrued interest is added to the principal balance on an annual basis until 2007. During 2004, \$240,000 of accrued interest was added to the principal balance of the note.

In January 2002, TCI purchased 100% of the outstanding common shares of ART Two Hickory Corporation (Two Hickory), a wholly-owned subsidiary of ARI for \$4.4 million cash. Two Hickory owns the 96,217 sq. ft. Two Hickory Centre Office Building in Farmers Branch, Texas. ARI guaranteed that the asset shall produce at least a 12.0% annual return of the purchase price for a period of three years from the purchase date. If the asset fails to produce the 12.0% annual return, ARI shall pay TCI any shortfall. In addition, if the asset fails to produce the 12.0% return for a calendar year and ARI fails to pay the shortfall, TCI may require ARI to repurchase the shares of Two Hickory for the purchase price. Because ARI guaranteed the 12.0% return and TCI has the option of requiring ARI to repurchase the entities, management has classified this related party transaction as a note receivable from ARI. In June 2002, the asset was refinanced. TCI received \$1.3 million of the proceeds as a principal reduction on its note receivable from ARI. In January 2005, TCI completed the purchase of Two Hickory by recording the asset and removing the note receivable from ARI.

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In April 2002, TCI purchased 100% of the following entities: ART One Hickory Corporation (One Hickory), Garden Confederate Point, LP (Confederate Point), Garden Foxwood, LP (Foxwood), and Garden Woodsong, LP (Woodsong), all previously wholly-owned subsidiaries of ARI for \$10.0 million. One Hickory owns the 120,615 sq. ft. One Hickory Centre Office Building in Farmers Branch, Texas. Confederate Point owned the 206 unit Confederate Apartments in Jacksonville, Florida. Foxwood owns the 220 unit Foxwood Apartments in Memphis, Tennessee. Woodsong owned the 190 unit Woodsong Apartments in Smyrna, Georgia. ARI guaranteed that these assets shall produce at least a 12.0% return annually of the purchase price for a period of three years from the purchase date. If the assets collectively fail to produce the 12.0% return, ARI shall pay TCI any shortfall. In addition, if the assets fail to produce the 12.0% return for a calendar year and ARI fails to pay the shortfall, TCI may require ARI to repurchase the entities for the purchase price. Because ARI guaranteed the 12.0% return and TCI has the option of requiring ARI to repurchase the entities, management has classified this related party transaction as a note receivable from ARI. In July 2002, the Woodsong Apartments were sold. ARI received \$2.8 million from the proceeds as payment of principal and accrued but unpaid interest on the note receivable. In October 2003, TCI sold One Hickory to IORI for \$12.2 million, less prorations, for a wraparound

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promissory note of \$12.0 million. This note bears interest at 5.49% interest, requires monthly interest and principal payments and matures in June 2006. This transaction effectively discharged the note receivable TCI had from ARI for the financing of One Hickory. Also, in November 2003, Confederate Point sold the Confederate Apartments and paid \$2.1 million to TCI to pay off the loan and accrued but unpaid interest.

In December 2001, TCI purchased 100% of the outstanding common shares of National Melrose, Inc. (NM), a wholly-owned subsidiary of ARI, a related party, for \$2.0 million cash. NM owns the 41,840 sq. ft. Executive Court Office Building in Memphis, Tennessee. ARI has guaranteed the asset will produce at least a 12.0% annual return of the purchase price for a period of three years from the purchase date. If the asset fails to produce the 12.0% annual return, ARI will pay TCI any shortfall. In addition, if the asset fails to produce 12.0% return for a calendar year, TCI may require ARI to repurchase the shares of NM for the purchase price. Management has classified this related party transaction as a note receivable from ARI. In December 2004, TCI recorded the purchase of the Executive Court Office Building by recording the asset and removing the note receivable from ARI. See Note 2. REAL ESTATE.

NOTE 4. ALLOWANCE FOR ESTIMATED LOSSES

Activity in the allowance for estimated losses was as follows:

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|---------------------------------|-------------|-----------------|-----------------|
| Balance January 1, | \$ 1,456 | \$ 1,337 | \$ 818 |
| Provision for loss | | | 169 |
| Fully reserved notes receivable | | 119 | 350 |
| Decrease in provision | (1,456) | | |
| Balance December 31, | <u>\$</u> | <u>\$ 1,456</u> | <u>\$ 1,337</u> |

NOTE 5. INVESTMENT IN EQUITY METHOD REAL ESTATE ENTITIES

Investment in equity method real estate entities consisted of the following:

2004 2003

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| | | |
|--|------------------|------------------|
| American Realty Investors, Inc. (ARI) | \$ 9,870 | \$ 9,654 |
| Income Opportunity Realty Investors, Inc. (IORI) | 5,765 | 4,423 |
| Garden Centura, L.P. | 1,925 | |
| Sacramento Nine (SAC 9) | | 219 |
| Other | 22 | (25) |
| | <u>\$ 17,582</u> | <u>\$ 14,271</u> |

TCI owns an approximate 6.5% interest in ARI, a publicly held real estate company, having a market value of \$108.9 million at December 31, 2004. At December 31, 2004, ARI had total assets of \$498.1 million and owned 21 apartments, nine commercial properties, seven hotels and 37 parcels of unimproved land. In 2004, ARI sold four apartments, three commercial properties and 13 parcels of unimproved land for a total of \$112.5 million, receiving net cash of \$18.3 million after paying off or being relieved of \$58.6 million in mortgage debt and the payment of various closing costs. ARI recognized gains of \$25.5 million on the sales of which TCI's equity share was \$1.7 million. In 2003, ARI sold 12 apartments, five commercial properties, two hotels and 18 parcels of unimproved land for a total of \$197.5 million, receiving net cash of \$37.8 million after

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paying off \$96.5 million in mortgage debt and the payment of various closing costs. ARI recognized gains of \$63.0 million on the sales of which TCI's equity share was \$4.1 million.

Based on the ownership percentage of TCI's investment in ARI and ARI's market value, TCI's investment in ARI has a market value of approximately \$7.2 million at December 31, 2004. The carrying value of this investment is approximately \$9.9 million at December 31, 2004. Management continues to believe the market value of ARI temporarily undervalues its assets and therefore, no impairment of TCI's investment in ARI has been recorded.

TCI owns an approximate 24.0% interest in IORI, a publicly held real estate investment company. At December 31, 2004, IORI had total assets of \$91.2 million and owned six apartments, one office building, one shopping center, one industrial warehouse, and one parcel of unimproved land, all within the State of Texas. In 2004, IORI sold two apartments, two office buildings and a parcel of unimproved land for a total of \$24.5 million, receiving net cash of \$4.8 million after paying off \$15.8 million in mortgage debt and the payment of various closing costs. IORI recognized gains of \$5.5 million on the sales of which TCI's equity share was \$1.3 million. In 2003, IORI sold three office buildings and a parcel of unimproved land for a total of \$55.7 million, receiving net cash of \$10.1 million after paying off \$9.5 million in mortgage debt and the payment of various closing costs. IORI recognized gains of \$3.0 million on the sales of which TCI's equity share was \$715,000.

Based on the ownership percentage of TCI's investment in IORI and IORI's market value, TCI's investment in IORI has a market value of approximately \$5.5 million at December 31, 2004. The carrying value of this investment is approximately \$5.8 million at December 31, 2004. Management continues to believe the market value of ARI temporarily undervalues its assets and therefore, no impairment of TCI's investment in IORI has been recorded.

In December 2004, TCI sold a 95% interest in Garden Centura, L.P. that owns the 410,901 sq. ft. Centura Tower office building located in Farmers Branch, Texas. TCI retained a non-controlling 1% general partner and 4% limited partner interest in Garden Centura, L.P. TCI will account for its investment in this partnership on the cost basis.

Prior to the first quarter of 2002, TCI accounted for its investments in Tri-City, Nakash and Jor-Trans on the equity method. TCI was a 63.7% limited partner and IORI was a 36.3% general partner in Tri-City, and TCI is a 60.0% general partner and IORI is a 40.0% limited partner in Nakash. TCI owns a 55% limited and general partnership interest in Jor-Trans. TCI makes all partnership operating and policy decisions of the partnerships and TCI has the right to approve the sale or refinancing of principal assets, or approve the acquisition of partnership assets. For Tri-City, IORI as general partner only had protective rights in the partnership. TCI and IORI share one of the same members of the Board of Directors. Consequently, because TCI has a greater than 50.0% ownership over the operations of Tri-City, Nakash and Jor-Trans, the operations of the partnership have been consolidated. In the first quarter of 2002, TCI began accounting for its investment in Tri-City, Nakash and Jor-Trans using a consolidated basis. The effect of these consolidations increased TCI's assets, liabilities, and minority interest in 2002 by \$5.4 million, \$3.9 million and \$1.5 million, respectively. In November 2002, Tri-City sold its only asset, a shopping center, for \$4.2 million. Tri-City received net cash of \$1.9 million after the payment of various closing costs. TCI received a distribution of \$1.2 million of the net proceeds and recognized a gain of \$431,000 on its investment in Tri-City. Also, in July 2003, TCI sold the Jor-Trans partnership, which owned the Lincoln

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Court Apartments, to the 45.0% limited partner in Jor-Trans for \$1.8 million. TCI recognized a gain of \$1.7 million on this transaction and has withdrawn from the partnership.

TCI is a non-controlling 30.0% general partner in SAC 9. In December 2004, SAC 9 sold the Prospect Park #29 office building for \$3.7 million, of which TCI received \$1.1 million after closing costs and fees. TCI recognized a gain on the sale of investment in SAC 9 of \$882,000 relating to this transaction.

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Set forth below are summarized financial data for the entities accounted for using the equity method:

| | 2004 | 2003 |
|--|------------------------|-------------------|
| | <u> </u> | <u> </u> |
| | (dollars in thousands) | |
| Real estate, net of accumulated depreciation (\$89,967 in 2004 and \$97,270 in 2003) | \$ 338,181 | \$ 402,309 |
| Notes receivable | 95,189 | 91,992 |
| Other assets | 169,027 | 165,559 |
| Notes payable | (383,342) | (448,930) |
| Other liabilities | (101,288) | (84,269) |
| | <u> </u> | <u> </u> |
| Shareholders/partners' capital | \$ 117,767 | \$ 126,661 |
| | <u> </u> | <u> </u> |

| | 2004 | 2003 | 2002 |
|--|-------------------|-------------------|-------------------|
| | <u> </u> | <u> </u> | <u> </u> |
| Rents and interest and other income | \$ 142,324 | \$ 114,529 | \$ 90,779 |
| Depreciation | (8,287) | (9,308) | (7,478) |
| Operating expenses | (118,854) | (117,167) | (108,788) |
| Gain on land sales | 3,844 | 41,865 | 16,727 |
| Interest expense | (39,020) | (39,245) | (49,524) |
| | <u> </u> | <u> </u> | <u> </u> |
| Income (loss) from continuing operations | (19,993) | (9,326) | (58,284) |
| Income (loss) from discontinued operations | (2,235) | (15,010) | (11,186) |
| Gain from sale of discontinued operations | 31,028 | 26,546 | 62,927 |
| | <u> </u> | <u> </u> | <u> </u> |
| Net income (loss) | \$ 8,800 | \$ 2,210 | \$ (6,543) |
| | <u> </u> | <u> </u> | <u> </u> |

TCI's equity share of:

| | 2004 | 2003 | 2002 |
|--|-------------------|-------------------|-------------------|
| | <u> </u> | <u> </u> | <u> </u> |
| Income (loss) before gain on sale of real estate | \$ (1,497) | \$ (4,291) | \$ (3,818) |
| Gain on sale of real estate | 3,884 | 4,853 | 5,013 |
| | <u> </u> | <u> </u> | <u> </u> |
| Net income (loss) | \$ 2,387 | \$ 562 | \$ 1,195 |
| | <u> </u> | <u> </u> | <u> </u> |

NOTE 6. MARKETABLE EQUITY SECURITIES

In March 2003, TCI obtained a loan in the amount of \$5.0 million to acquire equity securities of Realty Korea CR-REIT Co., Ltd. No. 1 representing approximately a 9.2% ownership interest. As of May 2003, the loan was paid in full. This investment is considered an available-for-sale security. TCI has recognized unrealized gains of \$1.6 million during 2004 due to an increase in market price since December 31, 2003.

NOTE 7. NOTES AND INTEREST PAYABLE

Notes and interest payable consisted of the following: