

Comstock Homebuilding Companies, Inc.

Form 10-Q

May 13, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant To Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended March 31, 2008

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 1-32375

Comstock Homebuilding Companies, Inc.

(Exact name of registrant as specified in its charter)

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Delaware
(State or other jurisdiction of
incorporation or organization)

20-1164345
(I.R.S. Employer

Identification No.)

11465 Sunset Hills Road

5th Floor

Reston, Virginia 20190

(703) 883-1700

(Address including zip code, and telephone number,
including area code, of principal executive offices)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one)

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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

As of May 1, 2008, 15,009,058 shares of the Class A common stock, par value \$.01 per share, and 2,733,500 shares of Class B common stock, par value \$0.01, of the Registrant were outstanding.

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COMSTOCK HOMEBUILDING COMPANIES, INC. AND SUBSIDIARIES

FORM 10-Q

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Table of Contents**COMSTOCK HOMEBUILDING COMPANIES, INC. AND SUBSIDIARIES****UNAUDITED CONSOLIDATED BALANCE SHEETS**

(Amounts in thousands, except per share data)

	March 31, 2008	December 31, 2007
ASSETS		
Cash and cash equivalents	\$ 14,169	\$ 6,822
Restricted cash	5,440	4,985
Receivables	721	370
Due from related parties	91	92
Real estate held for development and sale	203,504	203,860
Inventory not owned - variable interest entities	19,250	19,250
Property, plant and equipment, net	1,361	1,539
Other assets	4,189	22,058
TOTAL ASSETS	\$ 248,725	\$ 258,976
LIABILITIES AND SHAREHOLDERS' EQUITY		
Accounts payable and accrued liabilities	\$ 12,832	\$ 21,962
Obligations related to inventory not owned	19,050	19,050
Notes payable	149,317	141,214
Senior unsecured debt	13,438	30,000
TOTAL LIABILITIES	194,637	212,226
Commitments and contingencies (Note 10)		
Minority interest	228	231
SHAREHOLDERS' EQUITY		
Class A common stock, \$0.01 par value, 77,266,500 shares authorized, 15,128,915 and 15,120,955 issued and outstanding, respectively	151	151
Class B common stock, \$0.01 par value, 2,733,500 shares authorized, 2,733,500 issued and outstanding	27	27
Additional paid-in capital	156,798	155,998
Treasury stock, at cost (391,400 Class A common stock)	(2,439)	(2,439)
Accumulated deficit	(100,677)	(107,219)
TOTAL SHAREHOLDERS' EQUITY	53,860	46,519
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 248,725	\$ 258,976

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

Table of Contents**COMSTOCK HOMEBUILDING COMPANIES, INC. AND SUBSIDIARIES****UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS**

(Amounts in thousands, except per share data)

	Three Months Ended March 31,	
	2008	2007
Revenues		
Revenue - homebuilding	\$ 15,940	\$ 43,025
Revenue - other	436	3,698
Total revenue	16,376	46,723
Expenses		
Cost of sales - homebuilding	13,940	36,867
Cost of sales - other	28	3,624
Impairments and write-offs	832	891
Selling, general and administrative	4,546	8,225
Operating (loss)	(2,970)	(2,884)
Gain on troubled debt restructuring	(8,325)	
Other (income) expense, net	(1,185)	(344)
Income (loss) before minority interest	6,540	(2,540)
Minority interest	(2)	(1)
Total pre tax income (loss)	6,542	(2,539)
Income taxes benefit		(870)
Net income (loss)	\$ 6,542	\$ (1,669)
Basic earnings (loss) per share	\$ 0.40	\$ (0.11)
Basic weighted average shares outstanding	16,544	15,888
Diluted income (loss) per share	\$ 0.39	\$ (0.11)
Diluted weighted average shares outstanding	16,589	15,888

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

Table of Contents**COMSTOCK HOMEBUILDING COMPANIES, INC. AND SUBSIDIARIES****UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Amounts in thousands, except per share data)

	Three Months Ended March 31,	
	2008	2007
Cash flows from operating activities:		
Net income (loss)	\$ 6,542	\$ (1,669)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities		
Amortization and depreciation	178	224
Impairments and write-offs	832	891
Loss on disposal of assets		11
Minority interest	(2)	(1)
Gain on troubled debt restructuring	(8,325)	
Board of Directors compensation	50	
Amortization of stock compensation	25	591
Deferred income tax		896
Changes in operating assets and liabilities:		
Restricted cash	(455)	(1,751)
Receivables	(352)	3,124
Due from related parties	1	50
Real estate held for development and sale	(185)	11,725
Other assets	17,869	159
Accounts payable and accrued liabilities	(9,133)	(13,691)
Due to related parties		(1,062)
Net cash provided by (used in) operating activities	7,045	(504)
Cash flows from investing activities:		
Purchase of property, plant and equipment		(46)
Net cash (used in) investing activities		(46)
Cash flows from financing activities:		
Proceeds from notes payable and bridge loan	24,880	43,353
Proceeds from senior unsecured debt		30,000
Payments on junior subordinated debt		(30,000)
Payments on notes payable, senior unsecured debt and bridge loan	(24,583)	(46,412)
Proceeds from shares issued under employee stock purchase plan	5	27
Net cash provided by (used in) financing activities	302	(3,033)
Net increase (decrease) in cash and cash equivalents	7,347	(3,583)
Cash and cash equivalents, beginning of period	6,822	21,263
Cash and cash equivalents, end of period	\$ 14,169	\$ 17,680
Supplemental disclosure for non-cash activity:		
Interest incurred but not paid in cash	\$ 290	\$ 1,114
Warrants issued in connection with troubled debt restructuring	\$ 720	\$

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

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COMSTOCK HOMEBUILDING COMPANIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except per share data)

1. ORGANIZATION AND BASIS OF PRESENTATION

Comstock Companies, Inc. (the Company) was incorporated on May 24, 2004 as a Delaware corporation. On June 30, 2004, the Company changed its name to Comstock Homebuilding Companies, Inc.

On December 17, 2004, as a result of completing its initial public offering (IPO) of its Class A common stock, the Company acquired 100% of the outstanding capital stock of Comstock Holding Company, Inc. and subsidiaries (Comstock Holdings) by merger, which followed a consolidation that took place immediately prior to the closing of the IPO (the Consolidation). The Consolidation was effected through the mergers of Sunset Investment Corp., Inc. and subsidiaries and Comstock Homes, Inc. and subsidiaries and Comstock Service Corp., Inc. and subsidiaries (Comstock Service) with and into Comstock Holdings. Pursuant to the terms of the merger agreement, shares of Comstock Holdings were canceled and replaced by 4,333 and 2,734 shares Class A and B common stock of the Company, respectively. Both Class A and B common stock shares bear the same economic rights. However, for voting purposes, Class A stock holders are entitled to one vote for each share held while Class B stock holders are entitled to fifteen votes for each share held.

The mergers of Sunset Investment Corp., Inc. and subsidiaries and Comstock Homes, Inc. and subsidiaries with and into Comstock Holdings (collectively the Comstock Companies or Predecessor) and the Company's acquisition of Comstock Holdings was accounted for using the Comstock Companies' historical carrying values of accounting as these mergers were not deemed to be substantive exchanges. The merger of Comstock Service was accounted for using the purchase method of accounting as this was deemed to be a substantive exchange due to the disparity in ownership.

The Company's Class A common stock is traded on the NASDAQ National market under the symbol CHCI and has no public trading history prior to December 17, 2004.

The Company develops, builds and markets single-family homes, townhouses and condominiums in the Washington D.C., Raleigh, North Carolina and Atlanta, Georgia metropolitan markets. The Company also provides certain management and administrative support services to certain related parties.

The homebuilding industry is cyclical and significantly affected by changes in national and local economic, business and other conditions. During 2006, new home sales in our markets began to slow and that trend has continued into 2008, resulting in the impairments discussed in Note 2. In response to these conditions, the Company has significantly reduced selling, general and administrative expenses in order to align our cost structure with the current level of sales activity, slowed land acquisition, delayed land development and construction activities except where required for near term sales and has offered for sale various developed lots and land parcels that the Company believes are not needed based on current absorption rates.

Both the Company and its subsidiaries have secured debt which either matures or has curtailment obligations during 2008 and beyond. In our industry it is customary for lenders to renew and extend project facilities until the project is complete provided the loans are kept current. Since the Company is the guarantor of our subsidiaries' debt, any significant failure to negotiate renewals and extensions to this debt would severely compromise our liquidity and could jeopardize our ability to satisfy our capital requirements. Our recently reported and cured loan covenant violations, may at some point negatively impact our ability to renew and extend our debt.

The accompanying financial statements have been prepared assuming that the company will continue as a going concern, which contemplates the realization of assets and satisfaction of liabilities in the normal course of business. No adjustments have been provided as if the company were unable to continue as a going concern.

2. REAL ESTATE HELD FOR DEVELOPMENT AND SALE

Real estate held for development and sale includes land, land development costs, interest and other construction costs and is stated at cost or, when circumstances or events indicate that the real estate held for development or sale is impaired, at estimated fair value. Land, land development and indirect land development costs are accumulated by specific project and allocated to various lots or housing units within that project using specific identification and allocation based upon the relative sales value, unit or area methods. Direct construction costs are

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assigned to housing units based on specific identification. Construction costs primarily include direct construction costs and capitalized field overhead. Other costs are comprised of prepaid local government fees and capitalized interest and real estate taxes. Selling costs are expensed as incurred.

Estimated fair value is based on comparable sales of real estate in the normal course of business under existing and anticipated market conditions. The evaluation takes into consideration the current status of the property, various restrictions, carrying costs, costs of disposition and any other circumstances, which may affect fair value including management's plans for the property. Due to the large acreage of certain land holdings, disposition in the normal course of business is expected to extend over a number of years. A

Table of Contents**COMSTOCK HOMEBUILDING COMPANIES, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Amounts in thousands, except per share data)**

write-down to estimated fair value is recorded when the net carrying value of the property exceeds its estimated discounted fair value. These evaluations are made on a property-by-property basis as seen fit by management whenever events or changes in circumstances indicate that the net book value may not be recoverable.

Deteriorating market conditions, turmoil in the credit markets and increased price competition have continued to negatively impact the Company in 2008 resulting in reduced sales prices, increased customer concessions, reduced gross margins and extended estimates for project completion dates. As a result, the Company evaluated all of its projects to determine if recorded carrying amounts were recoverable. This evaluation resulted in an aggregate 2008 impairment charge of \$828 at two projects. Impairment charges are recorded as a reduction in our capitalized land and/or house costs. The impairment charge was calculated using a discounted cash flow analysis model, which is dependent upon several subjective factors, including the selection of an appropriate discount rate, estimated average sales prices and estimated sales pace. In performing its impairment modeling the Company must select what it believes is an appropriate discount rate based on current market cost of capital and returns expectations. The Company has used its best judgment in determining an appropriate discount rate based on anecdotal information it has received from marketing its deals for sale in recent months. The Company has elected to use a rate of 17% in its discounted cash flow model. While the selection of a 17% discount rate was subjective in nature, the Company believes it is an appropriate rate in the current market. The estimates used by the Company are based on the best information available at the time the estimates are made. If market conditions continue to deteriorate additional adverse changes to these estimates in future periods could result in further material impairment amounts to be recorded.

In addition, and from time to time, the Company will write-off deposits it has made for options on land that it has decided not to purchase. These deposits and any related capitalized pre-acquisition feasibility or project costs are written off at the earlier of the option expiration or the decision to terminate the option.

The following table summarizes impairment charges and write-offs for the three months ended:

	March 31, 2008	March 31, 2007
Impairments	\$ 828	\$
Write-offs	4	891
	\$ 832	\$ 891

After impairments and write-offs, real estate held for development and sale consists of the following:

	March 31, 2008	December 31, 2007
Land and land development costs	\$ 86,693	\$ 84,448
Cost of construction (including capitalized interest and real estate taxes)	116,811	119,412
	\$ 203,504	\$ 203,860

3. CONSOLIDATION OF VARIABLE INTEREST ENTITIES

The Company typically acquires land for development at market prices from various entities under fixed price purchase agreements. The purchase agreements require deposits that may be forfeited if the Company fails to perform under the agreements. The deposits required under

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the purchase agreements are in the form of cash or letters of credit in varying amounts. The Company may, at its option, choose for any reason and at any time not to perform under these purchase agreements by delivering notice of its intent not to acquire the land under contract. The Company's sole legal obligation and economic loss for failure to perform under these purchase agreements is typically limited to the amount of the deposit pursuant to the liquidated damages provision contained within the purchase agreement. As a result, none of the creditors of any of the entities with which the Company enters into forward fixed price purchase agreements have recourse to the general credit of the Company.

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The Company also does not share in an allocation of either the profit earned or loss incurred by any of these entities with which the Company has fixed price purchase agreements. The Company has concluded that whenever it options land or lots from an entity and pays a significant non-refundable deposit as described above, a variable interest entity is created under the provisions of Financial Accounting Standards Board (FASB) issued Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46-R). This is because the Company has been deemed to have provided subordinated financial support, which creates a variable interest which limits the equity holder's returns and may absorb some or all of an entity's expected theoretical losses if they occur. The Company, therefore, examines the entities with which it has fixed price purchase agreements for possible consolidation by the Company under FIN 46-R. This requires the Company to compute expected losses and expected residual returns based on the probability of future cash flows as outlined in FIN 46-R. This calculation requires substantial management judgments and estimates. In addition, because the Company does not have any contractual or ownership interests in the entities with which it contracts to buy the land, the Company does not have the ability to compel these development entities to provide financial or other data to assist the Company in the performance of the primary beneficiary evaluation.

The Company has evaluated its fixed price purchase agreement and has determined that it is the primary beneficiary of that entity. As a result, at March 31, 2008 and December 31, 2007, the Company consolidated one entity in the accompanying consolidated balance sheets. The effect of the consolidation was the inclusion of \$19,250 in Inventory not owned-variable interest entities with a corresponding inclusion of \$19,050 (net of land deposits paid of \$200) to Obligations related to inventory not owned. Creditors, if any, of this variable interest entity have no recourse against the Company.

4. WARRANTY RESERVE

Warranty reserves for houses settled are established to cover potential costs for materials and labor with regard to warranty-type claims expected to arise during the one-year warranty period provided by the Company or within the five-year statutorily mandated structural warranty period. Since the Company subcontracts its homebuilding work, subcontractors are required to provide the Company with an indemnity and a certificate of insurance prior to receiving payments for their work. Claims relating to workmanship and materials are generally the primary responsibility of the subcontractors and product manufacturers. The warranty reserve is established at the time of closing, and is calculated based upon historical warranty cost experience and current business factors. Variables used in the calculation of the reserve, as well as the adequacy of the reserve based on the number of homes still under warranty, are reviewed on a periodic basis. Warranty claims are directly charged to the reserve as they arise. The following table is a summary of warranty reserve activity which is included in accounts payable and accrued liabilities:

	Three Months Ended March 31,	
	2008	2007
Balance at beginning of period	\$ 1,537	\$ 1,669
Additions	180	232
Releases and/or charges incurred	(186)	(209)
Balance at end of period	\$ 1,531	\$ 1,692

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Interest and real estate taxes incurred relating to the development of lots and parcels are capitalized to real estate held for development and sale during the active development period, which generally commences when borrowings are used to acquire real estate assets and ends when the properties are substantially complete. Interest is capitalized based on the interest rate applicable to specific borrowings or the weighted average of the rates applicable to other borrowings during the period. Interest and real estate taxes capitalized to real estate held for development and sale are expensed as a component of cost of sales as related units are sold. The following table is a summary of interest incurred and capitalized. It does not include \$601 and \$0 of interest expensed in the period incurred during the three months ended March 31, 2008 and 2007, respectively, for projects that are currently considered inactive.

	Three Months Ended March 31,	
	2008	2007
Total interest incurred and capitalized	\$ 2,674	\$ 6,430
Interest expensed as a component of cost of sales	\$ (1,125)	\$ (4,014)

6. EARNINGS (LOSS) PER SHARE

The following weighted average shares and share equivalents are used to calculate basic and diluted earnings (loss) per share for the three months ended March 31, 2008 and 2007: