Comstock Homebuilding Companies, Inc.
Form 10-Q
August 14, 2008
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **Quarterly Report Pursuant To Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended June 30, 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)

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 x 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 x

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

As of August 13, 2008, 15,015,365 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.

Table of Contents

COMSTOCK HOMEBUILDING COMPANIES, INC. AND SUBSIDIARIES

FORM 10-Q

INDEX

Table of Contents

COMSTOCK HOMEBUILDING COMPANIES, INC. AND SUBSIDIARIES

UNAUDITED CONSOLIDATED BALANCE SHEETS

(Amounts in thousands, except per share data)

	June 30, 2008	December 31, 2007
ASSETS		
Cash and cash equivalents	$ 9,939	$ 6,822
Restricted cash	4,400	4,985
Receivables	118	370
Due from related parties	91	92
Real estate held for development and sale	186,512	203,860
Inventory not owned - variable interest entities	19,250	19,250
Property, plant and equipment, net	1,184	1,539
Other assets	2,817	22,058
TOTAL ASSETS	$ 224,311	$ 258,976
LIABILITIES AND SHAREHOLDERS EQUITY		
Accounts payable and accrued liabilities	$ 10,477	$ 21,962
Obligations related to inventory not owned	19,050	19,050
Notes payable	144,006	141,214
Senior unsecured debt	13,182	30,000
TOTAL LIABILITIES	186,715	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, 15,209,075 and 15,120,955 issued and outstanding, respectively	152	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	156,922	155,998
Treasury stock, at cost (391,400 Class A common stock)	(2,439)	(2,439)
Accumulated deficit	(117,294)	(107,219)
TOTAL SHAREHOLDERS EQUITY	37,368	46,519
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 224,311	$ 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 June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Revenues				
Revenue - homebuilding	$ 11,435	$ 110,313	$ 27,375	$ 153,338
Revenue - other	568	3,987	1,004	7,685
Total revenue	12,003	114,300	28,379	161,023
Expenses				
Cost of sales - homebuilding	10,260	102,876	24,200	139,743
Cost of sales - other		3,680	28	7,304
Impairments and write-offs	13,746	7,492	14,577	8,383
Selling, general and administrative	5,029	8,151	9,575	16,376
Operating loss	(17,032)	(7,899)	(20,001)	(10,783)
Gain on troubled debt restructuring			(8,325)	
Other income, net	(413)	(302)	(1,598)	(646)
Loss before minority interest	(16,619)	(7,597)	(10,078)	(10,137)
Minority interest	(1)	(3)	(3)	(5)
Total pre tax loss	(16,618)	(7,594)	(10,075)	(10,132)
Income taxes benefit		(2,926)		(3,796)
Net loss	$ (16,618)	$ (4,668)	$ (10,075)	$ (6,336)
Basic loss per share	$ (1.00)	$ (0.29)	$ (0.61)	$ (0.40)
Basic weighted average shares outstanding	16,541	16,095	16,502	15,992
Diluted loss per share	$ (1.00)	$ (0.29)	$ (0.61)	$ (0.40)
Diluted weighted average shares outstanding	16,541	16,095	16,502	15,992

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)

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Cash flows from operating activities:		
Net loss	$ (10,075)	$ (6,336)
Adjustment to reconcile net loss to net cash provided by operating activities		
Amortization and depreciation	355	446
Impairments and write-offs	14,577	8,383
Loss on disposal of assets		12
Minority interest	(3)	(5)
Gain on troubled debt restructuring	(8,325)	
Board of directors compensation	100	99
Amortization of stock compensation	49	1,167
Deferred income tax		1,149
Changes in operating assets and liabilities:		
Restricted cash	585	5,606
Receivables	252	1,581
Due from related parties	1	3,187
Real estate held for development and sale	3,062	70,160
Other assets	19,241	(2,693)
Accounts payable and accrued liabilities	(11,439)	(17,680)
Due to related parties		(1,000)
Net cash provided by operating activities	8,379	64,076
Cash flows from investing activities:		
Purchase of property, plant and equipment		(57)
Net cash used in investing activities		(57)
Cash flows from financing activities:		
Proceeds from notes payable	23,617	61,157
Proceeds from senior unsecured debt		30,000
Payments on junior subordinated debt		(30,000)
Payments on notes payable	(28,887)	(129,539)
Distributions paid to minority shareholders		(3)
Proceeds from shares issued under employee stock purchase plan	8	39
Net cash used in financing activities	(5,262)	(68,346)
Net increase (decrease) in cash and cash equivalents	3,117	(4,327)
Cash and cash equivalents, beginning of period	6,822	21,263
Cash and cash equivalents, end of period	$ 9,939	$ 16,936
Supplemental disclosure for non-cash activity:		
Interest incurred but not paid in cash	$ 290	$ 3,119

Warrants issued in connection with troubled debt restructuring	$	720	$	

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

Table of Contents

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 Global market under the symbol CHCI and has no public trading history prior to December 17, 2004. In January, 2008 the Company was notified by NASDAQ that it was not in compliance with requirements related to its listing on the NASDAQ Global Market. The Company was granted 180 days to regain compliance. On July 9, 2008 the Company was notified that it had not regained compliance and was going to be delisted from the NASDAQ Global Market. The Company requested a hearing, which is scheduled for September 4, 2008, to appeal this decision and seek an additional extension. The Company s stock will continue to trade on the NASDAQ Global Market pending the outcome of the hearing.

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 the 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 the 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.

Liquidity Developments in 2008

The Company and its subsidiaries have secured debt which either matures or has curtailment obligations during 2008 and beyond. Under normal market conditions it is customary for lenders in our industry to renew and extend debt obligations until the project is complete provided the loans are kept current. The Company is the guarantor of substantially all of its subsidiaries debt. As a result, any significant failure to negotiate renewals and extensions to this debt would severely compromise the Company s liquidity and would jeopardize the Company s ability to satisfy its capital requirements. As recently reported and as further discussed in Note 14, several of the Company s loan facilities have matured with no extensions negotiated. As a result, in the second quarter of 2008, the Company retained external consultants to act as an advisor in exploring debt restructuring alternatives. In connection with the exploration of available debt restructuring alternatives, the Company has elected to cease making certain scheduled interest and/or principal curtailment payments while it attempts to negotiate modifications or other satisfactory resolutions from its lenders. The current amount outstanding on the impacted facilities is approximately $93,000 as of June 30, 2008. Subsequent to this, the Company recently reported several loan covenant violations and notices of default from two of its lenders, Branch Bank & Trust

Company and Wachovia Bank, NA to which the Company owed approximately $57,000 as of June 30, 2008. These violations and notices may lead to foreclosures of assets and may also result in guarantee enforcement actions being initiated against the Company. In addition, many of the Company s loan facilities contain Material Adverse Effect clauses which, if invoked, could create an event of default under the loan. In the event all the Company s loans were deemed to be in default as a result of a Material Adverse Effect, the Company s ability to meet the capital and debt obligations would be compromised. The Company is in negotiations with the lenders impacted by the suspension of payments and interest to transfer the deed to certain projects to the lender in exchange for the settlement in full of any debt balance owed to the lender by the Company. The Company cannot at this time provide any assurances that it will be successful in these efforts. In the event the Company is not successful it may not be able to continue operations without filing a petition of bankruptcy.

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 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 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 during the second quarter of 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 impairment charge in the second quarter of 2008 of $13,740 across sixteen (16) projects. These impairment charges are recorded as a reduction in the Company s capitalized land and/or house costs.

Impairment charges of $500 were recorded across two (2) projects based on calculations 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

Table of Contents

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 were 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.

Table of Contents

COMSTOCK HOMEBUILDING COMPANIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except per share data)

In the second quarter of 2008, the Company retained an external consulting firm to act as an advisor in exploring debt restructuring alternatives. In connection with the exploration of available debt restructuring alternatives, the Company has elected to cease making certain scheduled interest and/or principal curtailment payments while it attempts to negotiate modifications or other satisfactory resolutions from its lenders. One emerging strategy for restructuring the Company s debt obligations is to transfer the deed to certain projects to the lender in exchange for the settlement in full of any debt balance owed to the lender by the Company. This is commonly referred to as a deed-in-lieu transaction. During the second quarter of 2008, the Company reduced the carrying value of the related assets to their estimated net realizable value which approximates the carrying value of the associated debt. While the Company believes the net realizable value of these assets are sufficient to fully repay the associated debt, there is no assurance that the Company will not be called upon by the lenders for any deficiency. This resulted in a reduction in asset carrying values of $13,240 across fourteen (14) projects which has been included in impairments and write-offs for the three months ended June 30, 2008.

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 and six months ended June 30, 2008 and 2007:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Impairments	$ 13,740	$ 7,350	$ 14,568	$ 7,350
Write-offs	6	142	9	1,033
	$ 13,746	$ 7,492	$ 14,577	$ 8,383

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

	June 30, 2008	December 31, 2007
Land and Land Development Costs	$ 71,889	$ 84,448
Cost of Construction (including capitalized interest and real estate taxes)	114,623	119,412
	$ 186,512	$ 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 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.

Table of Contents

COMSTOCK HOMEBUILDING COMPANIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except per share data)

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 relating to Phase II of Beacon Park and has determined that it is the primary beneficiary of that entity. As a result, at June 30, 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 relating to this purchase contract.

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 for the three and six months ended June 30, 2008 and 2007:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Balance at beginning period	$ 1,531	$ 1,692	$ 1,537	$ 1,669
Additions	36	346	216	577
Releases and/or charges incurred	(238)	(329)	(424)	(537)
Balance at end of period	$ 1,329	$ 1,709	$ 1,329	$ 1,709

Table of Contents

COMSTOCK HOMEBUILDING COMPANIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except per share data)

5. CAPITALIZED INTEREST AND REAL ESTATE TAXES

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 or the property becomes inactive which means that development and construction activities have been suspended indefinitely. 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. When a project becomes inactive its interest and real estate taxes are no longer capitalized but rather expensed as general and administrative costs of the period in which they are incurred. The following table is a summary of interest incurred and capitalized. It does not include $478 and $0 of interest expensed during the three months ended June 30, 2008 and 2007, respectively and $1,079 and $0 of interest expensed during the six months ended June 30, 2008 and 2007, respectively, for inactive projects. In the third quarter of 2008, the Company is planning to inactivate additional projects which will result in higher interest and real estate taxes expensed in future periods.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Total interest incurred and capitalized	$ 1,686	$ 7,412	$ 4,360	$ 13,842
Interest expensed as a component of cost of sales	$ (995)	$ (8,557)	$ (2,120)	$ (12,571)

6. LOSS PER SHARE

The following weighted average shares and share equivalents are used to calculate basic and diluted loss per share for the three and six months ended June 30, 2008 and 2007:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Basic loss per share				
Net loss	$ (16,618)	$ (4,668)	$ (10,075)	$ (6,336)
Basic weighted-average shares outstanding	16,541	16,095	16,502	15,992
Per share amounts	$ (1.00)	$ (0.29)	$ (0.61)	$ (0.40)
Dilutive loss per share				
Net loss	$ (16,618)	$ (4,668)	$ (10,075)	$ (6,336)
Basic weighted-average shares outstanding	16,541	16,095	16,502	15,992
Stock options and restricted stock grants				
Dilutive weighted-average shares outstanding	16,541	16,095	16,502	15,992

Per share amounts	$	(1.00)	$	(0.29)	$	(0.61)	$	(0.40)

During the three and six months ended June 30, 2008, 28,504 and 40,699 shares were excluded from the diluted shares outstanding because inclusion would have been anti-dilutive. During the three and six months ended June 30, 2007, 110,089 and 215,733 shares were excluded from the diluted shares outstanding because inclusion would have been anti-dilutive.

Comprehensive income

For the three and six months ended June 30, 2008 and 2007, comprehensive income equaled net income; therefore, a separate statement of comprehensive income is not included in the accompanying consolidated financial statements.

7. ACQUISITIONS

On January 19, 2006, the Company acquired all of the issued and outstanding capital stock of Parker Chandler Homes, Inc., a homebuilder in the Atlanta, Georgia metropolitan market, for a cash purchase price of $10,400 (including transaction costs) and the assumption of $63,800 in liabilities. The results of Parker Chandler Homes are included in the accompanying financial statements starting January 19, 2006. The Company accounted for this transaction in accordance with Statement of Financial Accounting Standards No. 141, *Business Combinations* (SFAS 141). Approximately $700 of the purchase price was allocated to intangibles with a weighted average life of 4.6 years. The intangibles are related to the Parker Chandler trade name, employment and non-compete agreements entered into with certain selling shareholders. The remainder of the purchase price was allocated to real estate held for development and sale and land option agreements. There was no goodwill associated with the transaction.

Table of Contents

COMSTOCK HOMEBUILDING COMPANIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except per share data)

On May 5, 2006, the Company acquired all of the issued and outstanding capital stock of Capitol Homes, Inc., a homebuilder in Raleigh, North Carolina, for a cash purchase price of $7,500 (including transaction costs) and the assumption of $20,600 in liabilities. The results of Capitol Homes are included in the accompanying financial statements starting May 5, 2006. The Company accounted for this transaction in accordance with SFAS 141. Approximately $251 of the purchase price was allocated to intangibles with a weighted average life of 2.7 years. The intangibles are related to the Capitol Homes trade name, employment and non-compete agreements entered into with certain selling shareholders. The remainder of the purchase price was allocated to real estate held for development and sale and land option agreements. There was no goodwill associated with the transaction.

Subsequent to each acquisition, as a result of the Company releasing the restrictive terms under the employment and non-compete agreements and the decision to no longer to use the respective trade names, all amounts assigned to intangibles were written off during the fourth quarter of 2006. During the third quarter of 2007, the Company elected to terminate numerous land option agreements acquired in both acquisitions. As a result, the purchase price allocated to land option agreements were substantially written off during the third quarter of 2007.

8. INCOME TAX

Income taxes are accounted for under the asset and liability method in accordance with SFAS 109 *Accounting for Income Taxes*. Deferred tax assets and liabilities are recognized for future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on the deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

For the six months ended June 30, 2008, the Company generated taxable income of approximately $6,600 for federal and state tax purposes. The $6,600 of taxable income includes approximately $5,600 of taxable income resulting from temporary timing differences related to the gain on the troubled debt restructuring (see Note 13). However, the Company is projecting a tax loss for 2008 based principally on the realization of current year tax deductions from prior year impairment charges. Therefore, an effective tax rate of zero was assumed in calculating the current income tax expense at June 30, 2008.

The Company s income tax (benefit) expense consists of the following as of:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Current:				
Federal	$	$ (2,678)	$	$ (4,168)
State		(500)		(777)
		(3,178)		(4,945)
Deferred:				
Federal	(3,812)	160	(4,400)	800
State	(709)	30	(818)	151
	(4,521)	190	(5,218)	951
Other:				
Valuation allowance	4,521		5,218	
Tax shortfall related to the vesting of certain equity awards		62		198

Total income tax benefit	$	$ (2,926)	$	$ (3,796)

Table of Contents

COMSTOCK HOMEBUILDING COMPANIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except per share data)

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Components of the Company s deferred tax assets and liabilities at June 30, 2008 and December 31, 2007 were as follows:

	June 30, 2008	December 31, 2007
Deferred tax assets:		
Inventory	$ 31,658	$ 26,632
Warranty	428	560
Investment in Affiliates	38	38
Net operating loss and tax credit carryforwards	862	2,543
Cancellation of debt gain	2,201	
Accrued expenses	272	531
Stock based compensation	(139)	(273)
	35,320	30,031
Less valuation allowance	(34,426)	(29,209)
Net deferred tax assets	894	822
Deferred tax liabilities:		
Depreciation and amortization	(894)	(822)
Net deferred tax liabilities	(894)	(822)
Net deferred tax assets (liabilities)	$	$

At December 31, 2007, the Company recorded valuation allowances for certain tax attributes and other deferred tax assets. At this time, sufficient uncertainty exists regarding the future realization of these deferred tax assets through future taxable income or carry back opportunities. If in the future the Company believes that it is more likely than not that these deferred tax benefits will be realized, the valuation allowances will be reversed.

In June 2006, the Financial Accounting Standards Board issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in accordance with SFAS No. 109, *Accounting for Income Taxes,* and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return.

The Company adopted the provisions of FIN 48 as of January 1, 2007. As a result of this adoption, the Company recorded a benefit to the opening accumulated deficit in the amount of $1,663. The Company recognizes interest accrued related to unrecognized tax benefits in interest expense. Penalties, if incurred, would be recognized as a component of general and administrative expense. At June 30, 2008, the Company had gross unrecognized tax benefits of $77, which was fully reserved. The reserve was limited to interest on the net timing difference. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

Balance as of December 31, 2007	$ 77
Additions for tax positions related the current year	
Additions for tax positions of prior years	
Reductions for tax positions of prior years	
Settlements	
Balance as of June 30, 2008	$ 77

The unrecognized tax benefits of $77 at June 30, 2008, would not reduce the Company annual effective tax rate if recognized. The Company has accrued interest and recorded a liability of $77 related to these unrecognized tax benefits during 2008. The Company does not expect the unrecognized tax benefits to change significantly over the next 12 months.

The Company files U.S. and state income tax returns in jurisdictions with varying statutes of limitations. The 2004 through 2007 tax years generally remain subject to examination by federal and most state tax authorities.

COMSTOCK HOMEBUILDING COMPANIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except per share data)

9. STOCK REPURCHASE PROGRAM

In February 2006 the Company s Board of Directors authorized the Company to purchase up to one million shares of the Company s Class A common stock in the open market or in privately negotiated transactions. The authorization did not include a specified time period in which the shares repurchase would remain in effect. During 2006, the Company repurchased an aggregate of 391,400 shares of Class A common stock for a total of $2,439 or $6.23 per share. There were no shares repurchased for the six months ended June 30, 2008 or in 2007 and the Company has no immediate plans to repurchase any additional shares under the existing authorization.

10. COMMITMENTS AND CONTINGENCIES

Litigation

In accordance with the provisions of its sales agreements, the Company s subsidiary retained the earnest money purchase deposits from Eclipse project buyers who defaulted on their obligation to settle. Certain buyers are seeking to obtain a refund of their forfeited deposits and have filed a series of lawsuits and arbitration claims commencing on or around June 28, 2007. Disputed deposits in an aggregate amount of approximately $644 remain in a segregated escrow account and are included in the accompanying financial statements as restricted cash as of June 30, 2008. For the three and six months ended June 30, 2008, the Company recognized $522 and $1,540 of income from forfeited earnest money purchase deposits from Eclipse buyers. This income is reported on the other (income) expense line in the statement of operations. The Company has filed counterclaims against the majority of the Eclipse buyers in the referenced actions.

On December 7, 2007, the Company and a subsidiary were served with a complaint and notice of lis pendens resulting from an allegation of the subsidiary s failure to pay $712 allegedly due to the seller of property in the District of Columbia known as the East Capitol project. The Company s subsidiary posted a cash escrow for 1.5 times the amount sought in the complaint in order to complete conveyance of the property without exception to title and intends to vigorously defend the matter.

The Company has asserted claims against former controlling shareholders of Parker-Chandler Homes, Inc., a homebuilder the Company acquired pursuant to a stock purchase agreement (SPA), dated January 19, 2006. The Company has made timely claims against the $1,000 holdback escrow account established pursuant to the SPA to secure reimbursement and indemnification as a result of a series of claims and liabilities created by certain omissions and/or misrepresentations allegedly made by the controlling shareholders in the SPA. The Company has reserved all rights and remedies with respect to the foregoing and certain additional matters.

On February 29, 2008, a wholly owned subsidiary of the Company, Mathis Partners, LLC (Mathis Partners), received notices of acceleration and foreclosure from Haven Trust Bank (Lender) pursuant to existing acquisition and construction credit facilities at its Gates of Luberon project. The aggregate outstanding balance of the indebtedness was approximately $4,800 as of the date of the notices. The notices were issued after maturity of the indebtedness and Mathis Partners inability to negotiate an extension of the credit facilities with Lender pursuant to terms and conditions Mathis Partners deemed satisfactory. On March 31, 2008, Mathis Partners, the special purpose entity that owns the Gates of Luberon project, filed a Chapter 11 reorganization, prohibiting a scheduled foreclosure sale of the Lender s collateral in the Gates of Luberon project from taking place. Mathis Partners is in the process of submitting a reorganization plan for court approval. In April 2008, the Lender filed a separate collection action against the Company pursuant to a guaranty agreement entered into by the Company for the outstanding balance of the indebtedness. Regardless of the outcome of the reorganization process by Mathis Partners, the Company may nevertheless be held responsible for the outstanding balance of the indebtedness through the collection action against the Company. The carrying value of Mathis Partners assets at June 30, 2008 is approximately $4,500.

On July 3, 2008, the Company and Comstock Belmont Bay 89, L.C. (the Subsidiary) were served with a complaint by Belmont Bay, LC (Seller) to enforce payment of a purchase money promissory note (Purchase Note) that matured on March 24, 2007, made by the Subsidiary and guaranteed by the Company with respect to our Beacon Park I Condominium at Belmont Bay (the Project). Demand is made for $1,993, plus accrued interest, costs and attorney fees. The Company and Subsidiary have filed answers to the action and the Subsidiary filed a counterclaim against the Seller as a result of its various breaches of the purchase contract that gave rise to the Purchase Note. On July 30, 2008, the Company and Subsidiary received notice of an additional complaint filed by Seller for breach of the purchase contract and on August 6, 2008, the Subsidiary was served with a third complaint by Seller and the master associations for the Belmont Bay development seeking injunctive relief to prohibit the Subsidiary from selling the Project. The Subsidiary and the Company intend to vigorously defend all actions and file various counterclaims against the Seller, the master association and certain individual constituent members of the associations as a result of their various contractual and fiduciary breaches.

On July 29, 2008, the general contractor for a subsidiary of the Company filed liens totaling approximately $500 at The Eclipse on Center Park project (Project) in connection with its claim for amounts allegedly owed under the Project contract documents. The Company s subsidiary is seeking to invalidate the liens based on a prior agreement under which the general contractor agreed not to file liens against the Project, regardless of the parties failure to reach settlement on claims each party has asserted against the other. In the event the subsidiary is unsuccessful in vacating or otherwise insuring the lien liability, it could be an event of default under the subsidiaries loan associated with the Project.

Other than the foregoing, the Company is not currently subject to any material legal proceedings. From time to time, however, the Company is named as a defendant in legal actions arising from the normal business activities. Although the Company cannot accurately predict the amount of the liability, if any, that could arise with respect to legal actions currently pending against the Company. The Company does not expect that any such liability will have a material adverse effect on the financial position, operating results or cash flows. The Company believes that it has obtained adequate insurance coverage, rights to indemnification, or where appropriate, has established reserves in connection with these legal proceedings.

COMSTOCK HOMEBUILDING COMPANIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except per share data)

Letters of credit and performance bonds

The Company has commitments as a result of contracts entered into with certain third parties to meet certain performance criteria as outlined in such contracts. The Company is required to issue letters of credit and performance bonds to these third parties as a way of ensuring that such commitments entered into are met by the Company. At June 30, 2008 the Company has issued $4,185 in letters of credit and $9,164 in performance and payment bonds to these third parties. No amounts have been drawn against these letters of credit and performance bonds. The Company estimates that it has approximately $3,465 of work to perform to complete the obligations covered by the letters of credit and performance bonds.

11. RELATED PARTY TRANSACTIONS

In April 2002 and January 2004, the Predecessor entered into lease agreements for approximately 7.7 and 8.8 square feet, respectively, for its corporate headquarters at 11465 Sunset Hills Road, Reston, Virginia from Comstock Partners, L.C. (now known as 11465 SH-I, LC), an affiliate of our Predecessor in which executive officers of the Company, Christopher Clemente, Gregory Benson, and others are principals. Christopher Clemente owns a 45% interest, Gregory Benson owns a 5% interest, an entity which is owned or controlled by Christopher Clemente s father-in-law, owns a 45% interest, and an unrelated third party owns a 5% interest in Comstock Partners. On September 30, 2004, the lease agreements were canceled and replaced with new leases for a total of 20.6 square feet with Comstock Asset Management, L.C., an entity wholly owned by Christopher Clemente. Total payments made under this lease agreement were $142 as of December 31, 2004. On August 1, 2005, the lease agreement was amended for an additional 8.4 square feet. On March 31, 2007 the lease agreement was amended decreasing the total square footage from 29.0 to 24.1 and extending the term for two additional years. In October 2007, the lease agreement was amended decreasing the total square footage from 24.1 to 17.1 and extending the term to four years through September 2011. For the three months ended June 30, 2008 and 2007, total payments made under this lease agreement were $137 and $192, respectively. During the six months ended June 30, 2008 and 2007 total payments were $285 and $384, respectively.

In May 2003, the Predecessor hired a construction company, in which Christopher Clemente s brother, serves as the President and is a significant shareholder, to provide construction services and act as a general contractor at the Company s Belmont Bay developments. For the three months ended June 30, 2008 and 2007 total payments made to the construction company were $0 and $423, respectively. The Company paid $0 and $2,320 to this construction company during the six months ended June 30, 2008 and 2007, respectively.

During 2003, the Predecessor entered into agreements with I-Connect, L.C., a company in which Investors Management, LLC, an entity wholly owned by Gregory Benson, holds a 25% interest, for information technology and website consulting services and the right to use certain customized enterprise software developed with input from the Company. The intellectual property rights associated with the software solution developed by I-Connect, along with any improvements made thereto by the Company, remain the property of I-Connect. For three months ended June 30, 2008 and 2007, the Company paid $50 and $134, respectively. During the six months ended June 30, 2008 and 2007, the Company paid $164 and $340, respectively, to I-Connect.

During the six months ended June 30, 2007, the Company entered into sales contracts to sell homes to certain employees of the Company. The Company, in order to attract, retain, and motivate employees maintains a home ownership benefit program. Under the home ownership benefits, an employee receives certain cost benefits provided by the Company when purchasing a home or having one built by the Company. Sales of homes to employees for investment purposes do not qualify for any cost benefits. The Company did not enter into any sales contracts with employees during the six months ended June 30, 2008.

In September 2005, Comstock Foundation, Inc. was created. Comstock Foundation is a not-for-profit organization organized exclusively for charitable purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code and is an affiliate of the Company. The affairs of Comstock Foundation are managed by a five-person board of directors with Christopher Clemente, Gregory Benson, Bruce Labovitz and Tracy Schar (employee of the Company and spouse of Christopher Clemente) being four of the five. The Company also provides bookkeeping services to Comstock Foundation at no charge. During the six months ended June 30, 2008 and 2007 the Company donated $5 and $0, respectively, to Comstock Foundation.

In February 2008, the Company entered into a Loan and Security Agreement with Stonehenge Funding, LC, a wholly-owned subsidiary of Comstock Asset Management, an entity wholly-owned by Christopher Clemente, the Chairman and Chief Executive Officer of the Company. The loan in the amount of $4,000 was secured by the Company s anticipated federal income tax refund for tax year 2007. Terms of the loan included interest-only payments at a fixed rate of 12% per annum and an origination fee paid by the Company to Stonehenge Funding at closing of the loan totaling $200. Participating in the loan were Gregory Benson ($500) and Tracy Schar ($1,500). In March 2008, the Company received its federal income tax refund and used a portion of the refund to settle the loan. Total interest payments of $16 were made to Stonehenge Funding.

Table of Contents

COMSTOCK HOMEBUILDING COMPANIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except per share data)

12. SEGMENT REPORTING

Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information* (SFAS 131) establishes standards for the manner in which companies report information about operating segments. The Company determined it provides one single type of business activity, homebuilding, which operates in multiple geographic or economic environments. In addition, as a result of the Company s acquisitions in Georgia and North Carolina, which became fully integrated in the fourth quarter of 2006, the Company modified how it analyzes its business during the fourth quarter of 2006. As such, the Company has determined that its homebuilding operations now primarily involve three reportable geographic segments: Washington DC Metropolitan Area, Raleigh, North Carolina, and Atlanta, Georgia. The aggregation criteria are based on the similar economic characteristics of the projects located in each of these regions.

The table below summarizes revenue and loss before income taxes for each of the Company s geographic segments (amounts in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Revenues:				
Washington DC Metropolitan Area	$ 6,252	$ 93,529	$ 12,751	$ 127,391
Raleigh, North Carolina	3,825	11,443	10,298	20,032
Atlanta, Georgia	1,926	9,328	5,330	13,600
Total revenue	$ 12,003	$ 114,300	$ 28,379	$ 161,023
Segment operating gain (loss)				
Washington DC Metropolitan Area	$ (6,492)	$ 581	$ (7,032)	$ 3,776
Raleigh, North Carolina	(286)	(646)	135	(835)