Forestar Group Inc.
Form 10-Q
November 04, 2010

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the quarterly period ended September 30, 2010

or

o **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: 001-33662

FORESTAR GROUP INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**26-1336998**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification No.)*

6300 Bee Cave Road, Building Two, Suite 500, Austin, Texas 78746

(Address of Principal Executive Offices, Including Zip Code)

(512) 433-5200

(Registrant s Telephone Number, Including Area Code)

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

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

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

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

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

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

Title of Each Class	Number of Shares Outstanding as of November 1, 2010
Common Stock, par value $1.00 per share	35,429,150

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PART I FINANCIAL INFORMATION

Item 1. ***Financial Statements***

FORESTAR GROUP INC.
Consolidated Balance Sheets

	(Unaudited) Third Quarter-End 2010	Year-End 2009
	(In thousands)	
ASSETS		
Cash and cash equivalents	$ 4,483	$ 21,051
Real estate	526,044	542,812
Assets held for sale	21,365	31,226
Investment in unconsolidated ventures	105,954	109,597
Timber	18,364	19,845
Receivables, net	33,884	1,841
Prepaid expenses	2,074	2,587
Income taxes receivable	5,411	
Property and equipment, net	5,300	5,234
Deferred tax asset	42,084	40,751
Other assets	12,060	9,790
TOTAL ASSETS	$ 777,023	$ 784,734
LIABILITIES AND SHAREHOLDERS EQUITY		
Accounts payable	$ 2,953	$ 4,573
Accrued employee compensation and benefits	847	4,025
Accrued property taxes	7,025	4,302
Accrued interest	1,011	871
Income taxes payable		2,809
Other accrued expenses	8,183	8,269
Other liabilities	28,218	24,924
Debt	217,566	216,626
TOTAL LIABILITIES	265,803	266,399
COMMITMENTS AND CONTINGENCIES		
EQUITY		
Forestar Group Inc. shareholders equity:		
Preferred stock, par value $0.01 per share, 25,000,000 authorized shares, none issued		
Common stock, par value $1.00 per share, 200,000,000 authorized shares, 36,639,885 issued at September 30, 2010 and 36,255,336 issued at December 31, 2009	36,640	36,255
Additional paid-in capital	389,763	384,795
Retained earnings	98,553	95,876

Accumulated other comprehensive loss		(256)
Treasury stock, at cost, 1,216,001 shares at September 30, 2010 and 209,544 shares at December 31, 2009	(19,444)	(4,214)
Total Forestar Group Inc. shareholders equity	505,512	512,456
Noncontrolling interests	5,708	5,879
TOTAL EQUITY	511,220	518,335
TOTAL LIABILITIES AND EQUITY	$ 777,023	$ 784,734

Please read the notes to the consolidated financial statements.

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FORESTAR GROUP INC.
Consolidated Statements of Income
(Unaudited)

	Third Quarter		First Nine Months	
	2010	2009	2010	2009
	(In thousands, except per share amounts)			
REVENUES				
Real estate sales	$ 10,000	$ 18,259	$ 36,895	$ 55,387
Commercial operating properties and other	5,139	4,662	17,041	14,768
Real estate	15,139	22,921	53,936	70,155
Mineral resources	6,654	18,828	18,387	31,767
Fiber resources and other	2,220	3,558	6,185	12,928
	24,013	45,307	78,508	114,850
COSTS AND EXPENSES				
Cost of real estate sales	(4,183)	(8,356)	(17,312)	(20,934)
Cost of commercial operating properties and other	(4,091)	(4,007)	(13,237)	(11,814)
Cost of mineral resources	(223)	(221)	(852)	(499)
Cost of fiber resources and other	(466)	(880)	(1,208)	(2,816)
Other operating	(10,163)	(9,923)	(29,203)	(29,717)
General and administrative	(4,797)	(8,000)	(16,493)	(22,758)
Gain on sale of assets	15,441	24,833	15,441	104,047
	(8,482)	(6,554)	(62,864)	15,509
OPERATING INCOME	15,531	38,753	15,644	130,359
Equity in earnings (loss) of unconsolidated ventures	82	(2,443)	740	(7,063)
Interest expense	(3,913)	(5,440)	(12,562)	(15,653)
Other non-operating income	246	287	690	382
INCOME BEFORE TAXES	11,946	31,157	4,512	108,025
Income tax expense	(2,860)	(10,956)	(1,507)	(39,761)
CONSOLIDATED NET INCOME	9,086	20,201	3,005	68,264
Less: Net income attributable to noncontrolling interests	(164)	(725)	(328)	(1,763)
NET INCOME ATTRIBUTABLE TO FORESTAR GROUP INC.	$ 8,922	$ 19,476	$ 2,677	$ 66,501
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING				
Basic	35,858	35,817	36,030	35,769

Diluted	36,379	36,173	36,596	35,975
NET INCOME PER COMMON SHARE				
Basic	$ 0.25	$ 0.54	$ 0.07	$ 1.86
Diluted	$ 0.25	$ 0.54	$ 0.07	$ 1.85

Please read the notes to the consolidated financial statements.

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FORESTAR GROUP INC.

Consolidated Statements of Cash Flows
(Unaudited)

	First Nine Months 2010	First Nine Months 2009
	(In thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Consolidated net income	$ 3,005	$ 68,264
Adjustments:		
Depreciation and amortization	7,231	7,390
Deferred income taxes	(1,470)	(21,153)
Tax benefits not recognized for book purposes	91	6,066
Equity in (earnings) loss of unconsolidated ventures	(740)	7,063
Distributions of earnings of unconsolidated ventures	1,184	259
Distributions of earnings to noncontrolling interests	(569)	(1,992)
Share-based compensation	7,370	7,717
Non-cash real estate cost of sales	15,387	19,040
Non-cash cost of assets sold	6,604	49,804
Real estate development and acquisition expenditures	(11,499)	(29,710)
Reimbursements from utility and improvement districts	495	22,299
Other changes in real estate	133	(637)
Gain on termination of timber lease	(617)	(195)
Cost of timber cut	1,141	2,577
Deferred income	1,655	(944)
Asset impairments	900	5,044
Loss on sale of assets held for sale	277	
Other	(51)	90
Changes in:		
Receivables	(32,359)	295
Prepaid expenses and other	570	307
Accounts payable and other accrued liabilities	(4,220)	(8,864)
Income taxes	(8,219)	23,389
Net cash (used for) provided by operating activities	(13,701)	156,109
CASH FLOWS FROM INVESTING ACTIVITIES:		
Property, equipment, software and reforestation	(2,282)	(6,317)
Investment in unconsolidated ventures	(1,538)	(1,916)
Return of investment in unconsolidated ventures	4,790	2,671
Proceeds from sale of assets held for sale	2,602	
Net cash provided by (used for) investing activities	3,572	(5,562)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments of debt	(22,551)	(155,948)
Additions to debt	36,698	43,512
Deferred financing fees	(5,969)	(3,127)
Return of investment to noncontrolling interest	(706)	(171)
Exercise of stock options	881	576

Repurchases of common stock	(15,178)	
Payroll taxes on restricted stock and stock options	(49)	(44)
Tax benefit from share-based compensation	121	
Other	314	70
Net cash used for financing activities	(6,439)	(115,132)
Net (decrease) increase in cash and cash equivalents	(16,568)	35,415
Cash and cash equivalents at beginning of period	21,051	8,127
Cash and cash equivalents at end of period	$ 4,483	$ 43,542

Please read the notes to the consolidated financial statements.

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FORESTAR GROUP INC.

Notes to the Consolidated Financial Statements
(Unaudited)

Note 1 Basis of Presentation

Our consolidated financial statements include the accounts of Forestar Group Inc., all subsidiaries, ventures and other entities in which we have a controlling interest and variable interest entities of which we are the primary beneficiary. We eliminate all material intercompany accounts and transactions. Noncontrolling interests in consolidated pass-through entities are recognized before income taxes. We account for our investment in other entities in which we have significant influence over operations and financial policies using the equity method (we recognize our share of the entities income or loss and any preferential returns and treat distributions as a reduction of our investment). We account for our investment in other entities in which we do not have significant influence over operations and financial policies using the cost method (we recognize as income distributions of accumulated earnings).

We prepare our unaudited interim financial statements in accordance with U.S. generally accepted accounting principles and Securities and Exchange Commission requirements for interim financial statements. As a result, they do not include all the information and disclosures required for complete financial statements. However, in our opinion, all adjustments considered necessary for a fair presentation have been included. Such adjustments consist only of normal recurring items unless otherwise noted. We make estimates and assumptions about future events. Actual results can, and probably will, differ from those we currently estimate including those related to allocating cost of sales to real estate, minerals and fiber and measuring assets for impairment. These interim operating results are not necessarily indicative of the results that may be expected for the entire year. For further information, please read the financial statements included in our 2009 Annual Report on Form 10-K.

Note 2 New and Pending Accounting Pronouncements

In first quarter 2010, we adopted Accounting Standards Update (ASU) 2009-17, *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*, ASU 2010-06, *Improving Disclosures about Fair Value Measurements* and ASU 2010-09, *Amendments to Certain Recognition and Disclosure Requirements*. Adoption of these pronouncements did not have a significant effect on our earnings or financial position but did result in certain additional disclosures.

ASU 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses* will be effective fourth quarter 2010. We do not anticipate that adoption will have a significant impact on our earnings or financial position but may result in additional disclosures.

Note 3 Strategic Initiatives and Assets Held for Sale

In 2009, we announced our near-term strategic initiatives to enhance shareholder value by: generating significant cash flow, principally from the sale of about 175,000 acres of higher and better use (HBU) timberland; reducing debt by approximately $150,000,000; and repurchasing up to 20 percent of our common stock.

In 2009, we sold about 95,000 acres of timber and timberland in Georgia and Alabama in two transactions generating net cash proceeds of $153,851,000, which were principally used to reduce debt and pay taxes.

In third quarter 2010, we sold about 14,100 acres of timber and timberland in Georgia and Alabama for $22,621,000 to East Coast Trading Co., Inc. in two separate transactions. These transactions generated net proceeds of $22,030,000, resulting in recognition of a $15,441,000 gain and $5,200,000 of deferred income tax expense. At third quarter-end 2010, the net proceeds from these transactions are held by a qualified intermediary as we plan to reinvest these proceeds in qualifying real estate, thereby deferring the gain for tax purposes under Internal Revenue Code Section 1031. As a result, the net proceeds are classified as a receivable pending reinvestment. We have until November 13, 2010 to identify qualified replacement properties, and until March 28, 2011 to acquire the identified properties. If we are unable to identify and close on the replacement properties within the required time periods, we will not be able to defer the gain for tax purposes and all deferred taxes related to these transactions will become currently payable.

At third quarter-end 2010, assets held for sale includes over 59,000 acres of undeveloped land with a carrying value of $13,517,000 and related timber with a carrying value of $7,848,000. These assets are actively being marketed.

In addition, we repurchased 1,000,987 shares of our common stock at a cost of $15,178,000 in third quarter 2010. The repurchased shares are classified as treasury stock.

In first quarter 2010, we sold our undivided interest in corporate aircraft resulting in net cash proceeds of $2,602,000 and loss on sale of assets of $277,000.

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Note 4 Real Estate

Real estate consists of:

	Third Quarter-End 2010	Year-End 2009
	(In thousands)	
Entitled, developed and under development projects	$ 412,309	$ 427,047
Undeveloped land	90,404	91,011
Commercial operating properties	46,156	49,171
	548,869	567,229
Accumulated depreciation	(22,825)	(24,417)
	$ 526,044	$ 542,812

Included in entitled, developed and under development projects are the estimated costs of assets we expect to convey to and be reimbursed by utility and improvement districts of $60,953,000 at third quarter-end 2010 and $60,863,000 at year-end 2009. Our Cibolo Canyons project located near San Antonio, Texas represents $37,052,000 of this amount at third quarter-end 2010 and $37,062,000 at year-end 2009. These costs relate to water, sewer and other infrastructure assets we have submitted to utility or improvement districts for review, approval and reimbursement. We submitted for reimbursement to these districts $3,316,000 in first nine months 2010 and $3,109,000 in first nine months 2009. We collected $495,000 from these districts in first nine months 2010 and $22,299,000 in first nine months 2009, of which $20,270,000 related to our Cibolo Canyons project and was accounted for as a reduction of our investment in the mixed-use development. We expect to collect the amounts submitted when these districts achieve adequate tax bases to support payment.

In first quarter 2010, entitled, developed and under development projects decreased by $11,865,000 due to lender foreclosure of a lien on a condominium property in Austin, Texas, owned by a consolidated variable interest entity. Please read Note 18 for additional information.

We recognized asset impairment charges in second quarter 2010 of $900,000 related to a residential real estate project located near Salt Lake City, Utah and $3,050,000 in first nine months 2009 related to the condominium project discussed above.

Depreciation expense, primarily related to commercial operating properties, was $2,067,000 in first nine months 2010 and $1,367,000 in first nine months 2009 and is included in other operating expenses.

Note 5 Timber

We have over 205,000 acres of timber, primarily in Georgia. The cost of timber cut and sold was $1,141,000 in first nine months 2010 and $2,577,000 in first nine months 2009.

Note 6 Noncontrolling Interests

A reconciliation of changes in shareholders equity at third quarter-end 2010 follows:

	Forestar Group Inc.	Noncontrolling Interests	Total
		(In thousands)	
Balance at year-end 2009	$ 512,456	$ 5,879	$ 518,335
Net income	2,677	328	3,005
Unrealized gain	256		256
Distributions to noncontrolling interests		(1,275)	(1,275)

Contributions from noncontrolling interests		776	776
Repurchases of common stock	(15,178)		(15,178)
Other (primarily share-based compensation)	5,301		5,301
Balance third quarter-end 2010	$ 505,512	$ 5,708	$ 511,220

Note 7 Investment in Unconsolidated Ventures

At third quarter-end 2010, we had ownership interests ranging from 25 to 50 percent in 10 ventures that we account for using the equity method. We have no real estate ventures that are accounted for using the cost method. Our three largest ventures at third quarter-end 2010 are CL Realty, Temco and Palisades West. We own a 50 percent interest in both CL Realty and Temco, and Cousins Real Estate Corporation owns the other 50 percent interest. We own a 25 percent interest in Palisades West, Cousins Properties Incorporated owns a 50 percent interest and Dimensional Fund Advisors LP owns the remaining 25 percent interest. Information regarding these ventures follows:

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CL Realty, L.L.C. was formed in 2002 for the purpose of developing residential and mixed-use communities in Texas and across the southeastern United States. At third quarter-end 2010, the venture had 14 residential and mixed-use communities, of which 10 are in Texas, 3 are in Florida and 1 is in Georgia, representing about 7,010 planned residential lots and 550 commercial acres.

Temco Associates, LLC was formed in 1991 for the purpose of acquiring and developing residential real estate sites in Georgia. At third quarter-end 2010, the venture has 5 residential and mixed-use communities, representing about 1,560 planned residential lots, all of which are located in Paulding County, Georgia. The venture also owns approximately 5,500 acres of undeveloped land in Paulding County, Georgia.

Palisades West LLC was formed in 2006 for the purpose of constructing a commercial office park in Austin, Texas. The project includes two office buildings totaling approximately 375,000 square feet and an accompanying parking garage. At third quarter-end 2010, the buildings are approximately 97 percent leased. Our remaining commitment for investment in this venture as of third quarter-end 2010 is $3,067,000. Effective fourth quarter 2008, we entered into a 10-year operating lease for approximately 32,000 square feet that we occupy as our corporate headquarters. In first nine months 2010, rents paid under this operating lease were $889,000 and are included in general and administrative expenses.

Combined summarized balance sheet information for our ventures accounted for using the equity method follows:

	Third Quarter-End 2010					Year-End 2009				
	CL Realty	Temco	Palisades West	Other Ventures	Total	CL Realty	Temco	Palisades West	Other Ventures	Total
					(In thousands)					
Real estate	$ 108,301	$ 60,411	$ 122,624	$ 70,458	$ 361,794	$ 113,169	$ 60,402	$ 122,566	$ 89,507	$ 385,644
Total assets	109,383	60,540	125,277	76,828	372,028	114,598	60,751	125,396	96,711	397,456
Borrowings (a)	2,911	2,963		73,711	79,585	3,568	3,061		77,113	83,742
Total liabilities	4,901	3,650	50,705(b)	84,593	143,849	5,414	3,268	51,158(b)	88,273	148,113
Equity	104,482	56,890	74,572	(7,765)	228,179	109,184	57,483	74,238	8,438	249,343
Our investment in real estate ventures:										
Our share of their equity (c)	52,241	28,445	18,643	14,594	113,923	54,592	28,742	18,559	15,673	117,566
Unrecognized deferred gain (d)	(7,059)			(910)	(7,969)	(7,059)			(910)	(7,969)
Investment in real estate ventures	$ 45,182	$ 28,445	$ 18,643	$ 13,684	$ 105,954	$ 47,533	$ 28,742	$ 18,559	$ 14,763	$ 109,597

Combined summarized income statement information for our ventures accounted for using the equity method follows:

	Third Quarter		First Nine Months	
	2010	2009	2010	2009

	(In thousands)			
Revenues:				
CL Realty	$ 1,120	$ 273	$ 5,332	$ 2,030
Temco	233	151	2,110	1,349
Palisades West	3,414	3,179	10,145	9,236
Other ventures	1,549	1,988	9,769	6,059
Total	$ 6,316	$ 5,591	$ 27,356	$ 18,674
Earnings (Loss):				
CL Realty [e]	$ 964	$ (3,479)	$ 2,184	$ (8,453)
Temco [f]	(382)	(1,457)	430	(2,400)
Palisades West	1,124	1,387	3,406	3,424
Other ventures	(524)	(1,344)	(16,807)	(1,668)
Total	$ 1,182	$ (4,893)	$ (10,787)	$ (9,097)
Our equity in their earnings (loss):				
CL Realty	$ 482	$ (1,739)	$ 1,092	$ (4,226)
Temco	(191)	(729)	215	(1,200)
Palisades West	281	347	850	856
Other ventures [c]	(490)	(322)	(1,417)	(2,493)
Total	$ 82	$ (2,443)	$ 740	$ (7,063)

(a) Total includes current maturities of $74,808,000 at third quarter-end 2010, of which $42,447,000 is non-recourse to us, and $80,625,000 at year-end 2009, of which $46,936,000 is non-recourse to us.

(b) Principally includes deferred income from leasehold improvements funded by tenants in excess of leasehold improvement allowances. These amounts are recognized as rental income over the lease term and are offset by depreciation expense related to these tenant improvements. There is no effect on venture net income.

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(c) Our share of the equity in other ventures reflects our ownership interests ranging from 25 to 50 percent, excluding venture losses that exceed our investment where we are not obligated to fund those losses.

(d) Represents deferred gains on real estate contributed by us to ventures. We are recognizing income as real estate is sold to third parties. The deferred gains are reflected as a reduction to our investment in unconsolidated ventures.

(e) CL Realty s loss includes impairment charges of $3,300,000 related to two residential real estate projects located in Tampa, Florida in third quarter 2009 and an impairment charge of $5,238,000 related to an equity investment in an unconsolidated venture in first nine months 2009.

(f) In third quarter 2009, Temco Associates loss includes an impairment charge of $1,263,000 related to a residential real estate project located in Atlanta, Georgia.

In first nine months 2010, we invested $1,538,000 in these ventures and received $5,974,000 in distributions; in first nine months 2009, we invested $1,916,000 in these ventures and received $2,930,000 in distributions. Distributions include both return of investments and distributions of earnings.

At third quarter-end 2010, other ventures include three partnerships we participate in that have $72,414,000 of borrowings classified as current maturities. These partnerships have total assets of $54,753,000 and other liabilities of $10,792,000. These partnerships are managed by third parties who intend to extend or refinance these borrowings; however, there is no assurance that this can be done. Although some of these borrowings are guaranteed by third parties, we may under certain circumstances elect or be required to provide additional equity to these partnerships. We do not believe that the ultimate resolution of these matters will have a significant effect on our earnings or financial position. Our investment in these partnerships is $3,183,000 at third quarter-end 2010. These three partnerships are variable interest entities. Please read Note 18 for additional information.

In first nine months 2010, other ventures loss includes a $13,061,000 loss on sale of a golf course and country club property in Denton, Texas. This loss did not impact our equity in the earnings (loss) of this venture as we exclude losses that exceed our investment where we are not obligated to provide additional equity.

We have provided performance bonds and letters of credit on behalf of certain ventures totaling $2,351,000 at third quarter-end 2010. Generally these performance bonds and letters of credit would be drawn on due to lack of performance by us or the ventures, such as failure to timely deliver streets and utilities in accordance with local codes and ordinances.

Note 8 Receivables

Receivables consist of:

	Third Quarter-End 2010	Year-End 2009
	(In thousands)	
Seller financing notes receivable, average interest rate of 6.49% at third quarter-end 2010 and 5.76% at year-end 2009	$ 949	$ 1,112
Note receivable, interest rate of 9.00% at third quarter-end 2010	10,000	
Due from qualified intermediary (see Note 3 for additional information)	22,630	
Accrued interest and other	449	873

	34,028	1,985
Allowance for bad debts	(144)	(144)
	$ 33,884	$ 1,841

Seller financing notes receivable generally are secured by a deed of trust with a minimum 10 percent down payment and are generally due within three years.

Note receivable represents our loan to a third-party equity investor in the JW Marriott ® San Antonio Hill Country Resort & Spa. The loan bears interest at 9 percent, increasing to 12 percent after July 2012, and is repayable at the earliest of refinancing or sale of the resort hotel or July 31, 2013. Borrowings are collateralized by pledges of funding commitments from the borrower, including our right to direct capital calls and to enforce rights under the fund operating agreement in the event of nonpayment.

Accrued interest and other receivables principally include miscellaneous operating receivables arising in the normal course of business.

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Note 9 Debt

Debt consists of:

	Third Quarter-End 2010	Year-End 2009
	(In thousands)	
Term loan facility average interest rate of 6.50% at third quarter-end 2010 and 5.54% at year-end 2009	$ 125,000	$ 125,000
Revolving loan facility average interest rate of 6.50% at third quarter-end 2010	19,000	
Secured promissory note interest rate of 3.76% at third quarter-end 2010 and 2.73% at year-end 2009	15,216	16,716
Other indebtedness due through 2011 at variable interest rates based on prime (3.75% at third quarter-end 2010 and 3.25% at year-end 2009) and fixed interest rates of 8.00%	58,350	74,910
	$ 217,566	$ 216,626

Our senior credit facility and other debt agreements contain terms, conditions and financial covenants customary for such agreements including minimum levels of interest coverage and limitations on leverage. At third quarter-end 2010, we were in compliance with the terms, conditions and financial covenants of these agreements.

On August 6, 2010, we entered into an amended and restated senior credit facility in order to consolidate previous amendments and to effect the following additional principal amendments to: extend the maturity date of the revolving loan to August 6, 2013 (with a one-year extension option to August 6, 2014) and of the term loan to August 6, 2015; reduce the revolving loan commitment to $175 million, subject to the ability to increase the aggregate facility by up to $150 million by securing additional commitments; eliminate any additional required commitment reductions during the term of the facility; reduce the interest coverage ratio from 1.75x to 1.05x; provide that during any period when the minimum interest coverage ratio falls below 1.50x, the interest rate on outstanding loans will increase by 2 percent and no new acquisitions, discretionary capital expenditures or distributions will be permitted; reduce the minimum value to commitment ratio from 1.75:1.00 to 1.60:1.00; and provide that if the interest coverage ratio does not exceed 3.0x, we may not repurchase our common stock. We incurred fees of about $5,700,000 related to this amendment.

At third quarter-end 2010, our senior credit facility provides for a $125,000,000 term loan and a $175,000,000 revolving line of credit. The term loan includes a prepayment penalty for payments in excess of $25,000,000 prior to February 6, 2012. The revolving line of credit may be prepaid at any time without penalty. The revolving line of credit includes a $100,000,000 sublimit for letters of credit, of which $3,071,000 is outstanding at third quarter-end 2010. Total borrowings under our senior credit facility (including the face amount of letters of credit) may not exceed a borrowing base formula. At third quarter-end 2010, we had $152,929,000 in net unused borrowing capacity under our senior credit facility.

At our option, we can borrow at LIBOR plus 4.5 percent (subject to a 2 percent LIBOR floor) or prime plus 2.5 percent. Borrowings under the senior credit facility are secured by (a) all timberland and minerals, (b) assignments of current and future leases, rents and contracts, including our mineral leases, (c) a security interest in our primary operating account, (d) pledge of the equity interests in current and future material operating subsidiaries or joint venture interests, or if such pledge is not permitted, a pledge of the right to distributions from such entities, and (e) negative pledge (without a mortgage) on all other wholly-owned assets. The senior credit facility provides for releases of real estate to be conveyed provided that borrowing base compliance is maintained.

At third quarter-end 2010, we have $7,617,000 in unamortized deferred fees which are included in other assets. Amortization of deferred financing fees was $3,543,000 in first nine months 2010 and $3,841,000 in first nine months 2009 and is included in interest expense.

At third quarter-end 2010, commercial operating properties having a book value of $23,157,000 are subject to liens in connection with $15,216,000 of debt.

At third quarter-end 2010, entitled, developed and under development projects having a book value of $127,882,000 are subject to liens in connection with $58,350,000 of principally non-recourse debt.

In first quarter 2010, other indebtedness decreased by $13,207,000 due to lender foreclosure of a lien on a condominium property in Austin, Texas owned by a consolidated variable interest entity. Please read Note 18 for additional information.

Note 10 Fair Value

Non-financial assets measured at fair value on a non-recurring basis principally include real estate assets and assets held for sale, which are measured for impairment. In second quarter 2010, a real estate asset was remeasured and reported at fair value due to events or circumstances that indicated the carrying value may not be recoverable. We determined estimated fair value based on the present value of future probability weighted cash flows expected from the sale of the long-lived asset. As a result, we recognized asset impairment of $900,000 in second quarter 2010. The carrying value of this asset may have subsequently increased or decreased from the fair value reflected due to activity that has occurred since the measurement date.

	Fair Value Measurements Level 1	Level 2	Level 3	Third Quarter-End 2010
		(In thousands)		
Non-Financial Assets				
Real estate	$	$	$ 756	$ 756

We elected not to use the fair value option for cash and cash equivalents, accounts receivable, other current assets, variable debt, accounts payable and other current liabilities. The carrying amounts of these financial instruments approximate their fair values due to their short-term nature or variable interest rates.

Information about our fixed rate financial instruments not measured at fair value follows:

	Third Quarter-End 2010		Year-End 2009		
	Carrying Amount	Fair Value	Carrying Amount	Fair Value	Valuation Technique
		(In thousands)			
Fixed rate notes receivable	$ 10,522	$ 12,594	$ 783	$ 831	Level 2
Fixed rate debt	(3,431)	(3,536)	(3,431)	(3,505)	Level 2

Note 11 Derivative Instruments

At third quarter-end 2010, we do not have any derivative instruments outstanding. In first quarter 2010, our $100,000,000 notional amount interest rate swap agreement matured, which was classified in other liabilities at year-end 2009. As a result, we recognized an after-tax gain of $256,000 in other comprehensive income. There was no hedge ineffectiveness over the term of the agreement.

Note 12 Capital Stock

Pursuant to our shareholder rights plan, each share of common stock outstanding is coupled with one-quarter of a preferred stock purchase right (Right). Each Right entitles our shareholders to purchase, under certain conditions, one one-hundredth of a share of newly issued Series A Junior Participating Preferred Stock at an exercise price of $100. Rights will be exercisable only if someone acquires beneficial ownership of 20 percent or more of our common shares or commences a tender or exchange offer, upon consummation of which they would beneficially own 20 percent or more of our common shares. We will generally be entitled to redeem the Rights at $0.001 per Right at any time until the 10th business day following public announcement that a 20 percent position has been acquired. The Rights will expire on December 11, 2017.

Please read Note 19 for information about additional shares of common stock that could be issued under terms of our share-based compensation plans.

As a result of the 2007 spin-offs from Temple-Inland, at third quarter-end 2010, personnel of Temple-Inland and the other spin-off entity held 20,000 awards that will be settled in shares of our common stock and options to purchase 1,267,000 shares of our common stock. Information about these stock options follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (Current Value Less Exercise Price)
	(In thousands)	(Per share)	(In years)	(In thousands)

Outstanding	1,267	$	20.47	4	$	2,432
Exercisable	1,225	$	20.12	4	$	2,432

Note 13 Other Comprehensive Income

Other comprehensive income consists of:

	Third Quarter		First Nine Months	
	2010	**2009**	**2010**	**2009**
	(In thousands)			
Consolidated net income	$ 9,086	$ 20,201	$ 3,005	$ 68,264
Change in fair value of interest rate swap agreement		400	393	968
Income tax effect of change in fair value		(140)	(137)	(339)
Other comprehensive income	9,086	20,461	3,261	68,893
Less: Comprehensive income attributable to noncontrolling interests	(164)	(725)	(328)	(1,763)
Other comprehensive income attributable to Forestar Group Inc.	$ 8,922	$ 19,736	$ 2,933	$ 67,130

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Note 14 Earnings per Share

Earnings available to common shareholders and weighted average common shares outstanding used to compute earnings per share were:

	Third Quarter		First Nine Months	
	2010	2009	2010	2009
	(In thousands)			
Earnings available to common shareholders:				
Consolidated net income	$ 9,086	$ 20,201	$ 3,005	$ 68,264
Less: Net income attributable to noncontrolling interest	(164)	(725)	(328)	(1,763)
Net income attributable to Forestar Group Inc.	$ 8,922	$ 19,476	$ 2,677	$ 66,501
Weighted average common shares outstanding basic	35,858	35,817	36,030	35,769
Dilutive effect of stock options	154	134	223	50
Dilutive effect of restricted stock and restricted stock units	367	222	343	156
Weighted average common shares outstanding diluted	36,379	36,173	36,596	35,975

At third quarter-end 2010 and 2009, the effect of 1,574,000 and 1,704,000 stock options and unvested shares of restricted stock were not included in the computation of diluted weighted average shares outstanding because they were anti-dilutive.

Note 15 Income Taxes

Our effective tax rate was 24 percent in third quarter 2010 and 33 percent in first nine months 2010 which includes a 4 percent benefit attributable to noncontrolling interests. Our effective tax rate was 35 percent in third quarter 2009 and 37 percent in first nine months 2009 which included less than a 1 percent benefit attributable to noncontrolling interests. Differences between the effective tax rate and the statutory rate are principally due to state income taxes, percentage depletion and nondeductible items. Our 2009 rate included a benefit from a federal income tax rate change for qualified timber gains due to the Food, Conservation and Energy Act of 2008 which expired in 2009.

We have not provided a valuation allowance for our deferred tax asset because we believe it is likely it will be recoverable in future periods.

At third quarter-end 2010, our unrecognized tax benefits totaled $7,581,000, of which $6,206,000 would affect our effective tax rate if recognized.

Note 16 Commitments and Contingencies

Litigation

We are involved in various legal proceedings that arise from time to time in the ordinary course of doing business and believe that adequate reserves have been established for any probable losses. We do not believe that the outcome of any of these proceedings should have a significant adverse effect on our financial position, long-term results of operations or cash flows. It is possible; however, that charges related to these matters could be significant to our results or cash flows in any one accounting period.

Environmental

Environmental remediation liabilities arise from time to time in the ordinary course of doing business, and we believe we have established adequate reserves for any probable losses. We own 288 acres near Antioch, California, portions of which were sites of a former Temple-Inland paper manufacturing operation that are in remediation. We estimate the cost to complete remediation activities will be about $3,500,000, which is included in other accrued expenses and will principally be paid in 2010 and 2011. Our estimate requires us to make assumptions regarding the scope of required remediation, the effectiveness of planned remediation activities, and approvals by regulatory authorities. Our estimate is subject to revision as new information becomes available.

Note 17 Segment Information

We manage our operations through three business segments: real estate, mineral resources and fiber resources. Real estate secures entitlements and develops infrastructure on our lands for single-family residential and mixed-use communities and manages our undeveloped land and our commercial operating properties. Mineral resources manages our oil, natural gas and water interests. Fiber resources manages our timber and recreational leases.

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Assets allocated by segment are as follows:

	Third Quarter-End 2010	Year-End 2009
	(In thousands)	
Real estate	$ 636,359	$ 654,250
Mineral resources	1,144	1,356
Fiber resources	18,666	20,088
Assets not allocated to segments	120,854	109,040
Total assets	$ 777,023	$ 784,734

We evaluate performance based on segment earnings before unallocated items and income taxes. Segment earnings (loss) consist of operating income, equity in earnings (loss) of unconsolidated ventures and net income (loss) attributable to noncontrolling interests. Unallocated items consist of general and administrative expense, share-based compensation, gain on sale of assets, interest expense and other non-operating income and expense. The accounting policies of the segments are the same as those described in the accounting policy note to the consolidated financial statements. Our revenues are derived from our U.S. operations and all of our assets are located in the U.S. In first nine months 2010, no single customer accounted for more than 10 percent of our total revenues.

Segment revenues and earnings are as follows:

	Third Quarter		First Nine Months	
	2010	2009	2010	2009
	(In thousands)			
Revenues:				
Real estate	$ 15,139	$ 22,921	$ 53,936	$ 70,155
Mineral resources	6,654	18,828	18,387	31,767
Fiber resources	2,220	3,558	6,185	12,928
Total revenues	$ 24,013	$ 45,307	$ 78,508	$ 114,850
Segment earnings (loss):				
Real estate	$ (1,883)	$ 92	$ 883	$ 5,641
Mineral resources	6,196	17,850	16,640	29,033
Fiber resources	1,372	2,080	3,900	8,279
Total segment earnings	5,685	20,022	21,423	42,953
Items not allocated to segments [a]	6,097	10,410	(17,239)	63,309
Income before taxes	$ 11,782	$ 30,432	$ 4,184	$ 106,262

[a] Items not allocated to segments consist of:

	Third Quarter		First Nine Months	
	2010	2009	2010	2009
	(In thousands)			
General and administrative expense	$ (3,860)	$ (5,874)	$ (13,438)	$ (17,750)
Share-based compensation expense	(1,817)	(3,396)	(7,370)	(7,717)
Gain on sale of assets	15,441	24,833	15,441	104,047
Interest expense	(3,913)	(5,440)	(12,562)	(15,653)
Other non-operating income	246	287	690	382
	$ 6,097	$ 10,410	$ (17,239)	$ 63,309

In third quarter 2010, gain on sale of assets represents the sale of about 14,100 acres of timber and timberland in Georgia and Alabama for $22,621,000.

In third quarter 2010, share-based compensation expense decreased as a result of a decline in our stock price and its impact on cash-settled awards.

In third quarter and first nine months 2010, interest expense decreased as a result of lower debt levels.

In third quarter 2009, general and administrative expense includes a $1,753,000 non-cash impairment charge related to our undivided 15 percent interest in corporate aircraft contributed to us by Temple-Inland at spin-off. In first nine months 2009, general and administrative expense includes about $3,200,000 paid to outside advisors regarding an evaluation by our Board of Directors of an unsolicited shareholder proposal.

In third quarter 2009, gain on sale of assets principally represents the sale of about 20,000 acres of timber and timberland in Georgia for $38,901,000. In first nine months 2009, gain on sale of assets of $104,047,000 represents the sale of about 95,000 acres of timber and timberland in Georgia and Alabama for $158,603,000.

Note 18 Variable Interest Entities

We participate in real estate ventures for the purpose of acquiring and developing residential and mixed-use communities in which we may or may not have a controlling financial interest. Generally accepted accounting principles require consolidation of variable interest entities (VIE) in which an enterprise has a controlling financial interest and is the primary beneficiary. A controlling financial interest will have both of the following characteristics: (a) the power to direct the VIE activities that most significantly impact economic performance and (b) the obligation to absorb the VIE losses and right to receive benefits that are significant to the VIE. We examine specific criteria and use judgment when determining whether we are the primary beneficiary and must consolidate a VIE. We perform this review initially at the time we enter into venture agreements and subsequently when reconsideration events occur.

At third quarter-end 2010, we are the primary beneficiary of two VIEs that we consolidate. We have provided the majority of equity to these VIEs, which absent our contributions or advances do not have sufficient equity to fund their operations. We have the authority to approve project budgets and the issuance of additional debt. At third-quarter end 2010, our consolidated balance sheet includes $15,153,000 in assets, principally real estate, and $7,993,000 in liabilities, principally debt, related to these two VIEs. In first nine months 2010, we contributed or advanced $1,311,000 to these VIEs. In first quarter 2010, real estate assets decreased by $11,865,000, debt decreased by $13,207,000 and other liabilities increased by $1,342,000 due to lender foreclosure of a lien on property owned by one of these VIEs. We have a nominal general partner interest in this VIE and could be held responsible for its liabilities.

Also at third quarter-end 2010, we are not the primary beneficiary of three VIEs that we account for using the equity method. The unrelated managing partners oversee the day-to-day operations and guarantee some of the debt of the VIEs while we have the authority to approve project budgets and the issuance of additional debt. Although some of the debt is guaranteed by the managing partners, we may under certain circumstances elect or be required to provide additional funds to these VIEs. At third quarter-end 2010, these three VIEs have total assets of $54,753,000, substantially all of which represent developed and undeveloped real estate and total liabilities of $83,207,000, which includes $72,414,000 of borrowings classified as current maturities. These amounts are included in other ventures in the combined summarized balance sheet information for ventures accounted for using the equity method in Note 7. At third quarter-end 2010, our investment in these three VIEs is $3,183,000 and is included in investment in unconsolidated ventures. We did not make any contributions or advances to these ventures in first nine months 2010. Our maximum exposure to loss related to these VIEs is estimated at $37,289,000, which exceeds our investment as we have a nominal general partner interest in two of these VIEs and could be held responsible for their liabilities. The maximum exposure to loss represents the maximum loss that we could be required to recognize assuming all the ventures assets (principally real estate) are worthless, without consideration of the probability of a loss or of any actions we may take to mitigate any such loss.

Note 19 Share-Based Compensation

A summary of the awards granted under our 2007 Stock Incentive Plan follows.

Cash-settled awards

Cash-settled awards granted to our employees in the form of restricted stock units or stock appreciation rights vest over two to four years from the date of grant and generally provide for accelerated vesting upon death, disability or if there is a change in control. Vesting for some restricted stock unit awards is also conditioned upon achievement of a minimum one percent annualized return on assets over a three-year period. Cash-settled stock appreciation rights have a ten-year term, generally become exercisable ratably over three to four years and provide for accelerated or continued vesting upon retirement, death, disability or if there is a change in control. Stock appreciation rights were granted with an exercise price equal to the market value of our stock on the date of grant.

Cash-settled awards granted to our directors in the form of restricted stock units are fully vested at the time of grant and payable upon retirement.

The following table summarizes the activity of cash-settled awards in first nine months 2010:

	Equivalent Units (In thousands)	Weighted Average Grant Date Fair Value (Per unit)
Non-vested at beginning of period	1,005	$ 5.35
Granted	399	12.68
Vested	(264)	7.18
Forfeited	(15)	6.58
Non-vested at end of period	1,125	$ 7.51

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The fair value of awards settled in cash was $731,000 in first nine months 2010 and $22,000 in first nine months 2009. At third quarter-end 2010, the fair value of vested cash-settled awards is $10,462,000 and is included in other liabilities. The aggregate current value of non-vested awards is $10,571,000 at third quarter-end 2010 based on a third quarter-end stock price of $17.05.

Restricted stock

Restricted stock awards vest either ratably over or after three years, generally if we achieve a minimum one percent annualized return on assets over such three-year period. The following table summarizes the activity of restricted stock awards in first nine months 2010:

	Restricted Shares (In thousands)	Weighted Average Grant Date Fair Value (Per share)
Non-vested at beginning of period	331	$ 17.43
Granted	308	17.80
Vested		
Forfeited	(3)	28.20
Non-vested at end of period	636	$ 17.56

The aggregate current value of non-vested awards is $10,849,000 at third quarter-end 2010 based on a third quarter-end stock price of $17.05.

Stock options

Stock options have a ten-year term, generally become exercisable ratably over three to four years and provide for accelerated or continued vesting upon retirement, death, disability or if there is a change in control. Options were granted with an exercise price equal to the market value of our stock on the date of grant. The following table summarizes the activity of stock option awards in first nine months 2010:

	Options Outstanding (In thousands)	Weighted Average Exercise Price (Per share)	Weighted Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value (Current Value Less Exercise Price) (In thousands)
Balance at beginning of period	780	$ 24.80	8	$ 2,052
Granted	181	17.80		
Exercised				
Forfeited	(4)	28.85		
Balance at end of period	957	$ 23.45	8	$ 1,255
Exercisable at end of period	395	$ 26.85	7	$ 314

We estimate the fair value of stock options using the Black-Scholes option pricing model and the following assumptions:

	First Nine Months	
	2010	2009
Expected dividend yield	0.0%	0.0%
Expected stock price volatility	51.0%	41.8%
Risk-free interest rate	2.3%	1.8%
Expected life of options (years)	6	6
Weighted average estimated fair value of options granted	$ 8.98	$ 3.94

We have limited historical experience as a stand-alone company so we utilized alternative methods in determining our valuation assumptions. The expected life was based on the simplified method utilizing the midpoint between the vesting period and the contractual life of the awards. The expected stock price volatility was based on historical prices of our peers common stock for a period corresponding to the expected life of the options. Pre-vesting forfeitures are estimated based upon the pool of participants and their expected activity and historical trends.

Pre-Spin Awards

Certain of our employees participated in Temple-Inland s share-based compensation plans. In conjunction with the 2007 spin-off, these awards were equitably adjusted into separate awards of the common stock of Temple-Inland and the spin-off entities.

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Cash-settled awards generally vest and are paid after three years from the date of grant or the attainment of defined performance goals, generally measured over a three-year period. To settle vested cash awards, we paid $1,904,000 in first nine months 2010 and $394,000 in first nine months 2009. At third quarter-end 2010, there are no remaining cash-settled awards.

Stock options have a ten-year term, generally become exercisable ratably over four years and provide for accelerated or continued vesting upon retirement, death, disability or if there is a change in control. A summary of stock option awards outstanding at third quarter-end 2010 follows:

	Options Outstanding (In thousands)	Weighted Average Exercise Price (Per share)	Weighted Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value (Current Value Less Exercise Price) (In thousands)
Outstanding on Forestar stock	81	$ 21.60	4	$ 149
Outstanding on Temple-Inland stock	171	20.07	5	286
				$ 435