

TRANSCONTINENTAL REALTY INVESTORS INC  
Form 10-Q  
November 14, 2017

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

---

**FORM 10-Q**

---

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

For the quarterly period ended September 30, 2017

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 001-09240

---

**TRANSCONTINENTAL REALTY INVESTORS, INC.**

**(Exact Name of Registrant as Specified in Its Charter)**

---

Nevada 94-6565852  
(State or Other Jurisdiction of (I.R.S. Employer

Incorporation or Organization) Identification No.)

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

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

---

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

Large accelerated filer Accelerated filer  
Emerging growth company

Non-accelerated  
filer (do not check if a  
smaller reporting  
company) Smaller reporting company

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

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

Common Stock, \$.01 par value	8,717,767
(Class)	(Outstanding at November 14, 2017)

**TRANSCONTINENTAL REALTY INVESTORS, INC.  
FORM 10-Q**

**TABLE OF CONTENTS**

	<b>PAGE</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
<b><u>Item 1. Financial Statements</u></b>	
<u>Consolidated Balance Sheets at September 30, 2017 (unaudited) and December 31, 2016</u>	3
<u>Consolidated Statements of Operations for the three and nine months ended September 30, 2017 and 2016 (unaudited)</u>	4
<u>Consolidated Statement of Shareholders' Equity for the nine months ended September 30, 2017 (unaudited)</u>	5
<u>Consolidated Statements of Comprehensive Income (Loss) for the nine months ended September 30, 2017 and 2016 (unaudited)</u>	6
<u>Consolidated Statements of Cash Flows for the nine months ended September 30, 2017 and 2016 (unaudited)</u>	7
<u>Notes to Consolidated Financial Statements</u>	8
<b><u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>	19
<b><u>Item 3. Quantitative and Qualitative Disclosures About Market Risks</u></b>	28
<b><u>Item 4. Controls and Procedures</u></b>	28
<b><u>PART II. OTHER INFORMATION</u></b>	
<b><u>Item 5. Unregistered Sales of Equity Securities and Use of Proceeds</u></b>	29
<b><u>Item 6. Exhibits</u></b>	30
<b><u>SIGNATURES</u></b>	31

**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****TRANSCONTINENTAL REALTY INVESTORS, INC.  
CONSOLIDATED BALANCE SHEETS**

	September 30, 2017 <b>(unaudited)</b> <b>(dollars in thousands, except share and par value amounts)</b>	December 31, 2016
<b>Assets</b>		
Real estate, at cost	\$ 1,054,884	\$ 998,498
Real estate subject to sales contracts at cost, net of depreciation	46,403	46,956
Less accumulated depreciation	(172,352 )	(154,281 )
Total real estate	928,935	891,173
Notes and interest receivable:		
Performing (including \$45,658 in 2017 and \$67,912 in 2016 from related parties)	64,523	81,133
Less allowance for doubtful accounts (including \$1,825 in 2017 and 2016 from related parties)	(1,825 )	(1,825 )
Total notes and interest receivable	62,698	79,308
Cash and cash equivalents	57,978	17,506
Restricted cash	42,752	38,227
Investments in unconsolidated joint ventures and investees	2,435	2,446
Receivable from related party	107,696	101,649
Other assets	48,233	55,605
Total assets	\$ 1,250,727	\$ 1,185,914
<b>Liabilities and Shareholders' Equity</b>		
<b>Liabilities:</b>		
Notes and interest payable	\$ 826,050	\$ 835,528
Notes related to real estate held for sale	376	376
Notes related to real estate subject to sales contracts	3,939	5,612
Bond and bond interest payable	107,910	—
Deferred revenue (including \$40,877 in 2017 and \$50,689 in 2016 to related parties)	60,940	71,065
Accounts payable and other liabilities (including \$7,072 in 2017 and \$6,487 in 2016 to related parties)	35,796	48,856
Total liabilities	1,035,011	961,437

Shareholders' equity:

Preferred stock, Series C: \$0.01 par value, authorized 10,000,000 shares; issued and outstanding zero shares in 2017 and 2016. Series D: \$0.01 par value, authorized, issued and outstanding 100,000 shares in 2017 and 2016 (liquidation preference \$100 per share)	1	1
Common stock, \$0.01 par value, authorized 10,000,000 shares; issued 8,717,967 shares in 2017 and 2016; outstanding 8,717,767 shares in 2017 and 2016	87	87
Treasury stock at cost, 200 shares in 2017 and 2016	(2 )	(2 )
Paid-in capital	269,179	269,849
Retained earnings	(72,519 )	(64,050 )
Total Transcontinental Realty Investors, Inc. shareholders' equity	196,746	205,885
Non-controlling interest	18,970	18,592
Total shareholders' equity	215,716	224,477
Total liabilities and shareholders' equity	\$ 1,250,727	\$ 1,185,914

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
<b>Revenues:</b>				
Rental and other property revenues (including \$199 and \$174 for the three months and \$589 and \$521 for the nine months ended 2017 and 2016, respectively, from related parties)	\$ 31,491	\$ 29,776	\$ 94,328	\$ 89,200
<b>Expenses:</b>				
Property operating expenses (including \$236 and \$221 for the three months and \$696 and \$644 for the nine months ended 2017 and 2016, respectively, from related parties)	15,157	15,413	46,256	45,295
Depreciation and amortization	6,326	6,014	19,008	17,665
General and administrative (including \$1,018 and \$753 for the three months and \$2,134 and \$1,501 for the nine months ended 2017 and 2016, respectively, from related parties)	1,594	1,541	4,669	4,754
Net income fee to related party	53	67	189	193
Advisory fee to related party	2,595	2,394	7,402	7,096
Total operating expenses	25,725	25,429	77,524	75,003
Net operating income	5,766	4,347	16,804	14,197
<b>Other income (expenses):</b>				
Interest income (including \$3,041 and \$4,249 for the three months and \$10,670 and \$10,269 for the nine months ended 2017 and 2016, respectively, from related parties)	3,175	4,251	10,305	11,386
Other income	190	8	1,529	1,178
Mortgage and loan interest (including \$347 and \$212 for the three months and \$784 and \$437 for the nine months ended 2017 and 2016, respectively, from related parties)	(14,245 )	(13,568 )	(45,218 )	(38,826 )
Earnings (losses) from unconsolidated joint ventures and investees	7	—	(11 )	(2 )
Foreign currency transaction gain (loss)	1,906	—	(1,841 )	—
Total other expenses	(8,967 )	(9,309 )	(35,236 )	(26,264 )
Loss before gain on sale of income-producing properties, gain on land sales, non-controlling	(3,201 )	(4,962 )	(18,432 )	(12,067 )

interest, and taxes

Gain on sale of income-producing properties	9,841	—	9,841	4,925
Gain on land sales	530	555	500	3,925
Net income (loss) from continuing operations before taxes	7,170	(4,407 )	(8,091 )	(3,217 )
Income tax expense	—	(25 )	—	(24 )
Net income (loss) from continuing operations	7,170	(4,432 )	(8,091 )	(3,241 )
Discontinued operations:				
Net income from discontinued operations	—	—	—	3
Income tax expense from discontinued operations	—	—	—	(1 )
Net income from discontinued operations	—	—	—	2
Net income (loss)	7,170	(4,432 )	(8,091 )	(3,239 )
Net income attributable to non-controlling interest	(96 )	(114 )	(378 )	(189 )
Net income (loss) attributable to Transcontinental Realty Investors, Inc.	7,074	(4,546 )	(8,469 )	(3,428 )
Preferred dividend requirement	(224 )	(227 )	(670 )	(673 )
Net income (loss) applicable to common shares	\$ 6,850	\$ (4,773 )	\$ (9,139 )	\$ (4,101 )
Earnings per share - basic				
Net income (loss) applicable to common shares	\$ 0.79	\$ (0.55 )	\$ (1.05 )	\$ (0.47 )
Earnings per share - diluted				
Net income (loss) applicable to common shares	\$ 0.79	\$ (0.55 )	\$ (1.05 )	\$ (0.47 )
Weighted average common shares used in computing earnings per share	8,717,767	8,717,767	8,717,767	8,717,767
Weighted average common shares used in computing diluted earnings per share	8,717,767	8,717,767	8,717,767	8,717,767
Amounts attributable to Transcontinental Realty Investors, Inc.				
Net income (loss) from continuing operations	\$ 7,074	\$ (4,546 )	\$ (8,469 )	\$ (3,430 )
Net income from discontinued operations	—	—	—	2
Net income (loss)	\$ 7,074	\$ (4,546 )	\$ (8,469 )	\$ (3,428 )

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



**TRANSCONTINENTAL REALTY INVESTORS, INC.**  
**CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY**  
**For the Nine Months Ended September 30, 2017**  
**(unaudited, dollars in thousands)**

	Total Equity	Comprehensive Income (Loss)	Preferred Stock	Common Stock Shares	Amount	Treasury Stock	Paid-in Capital	Retained Earnings	Non-control Interest
Balance, December 31, 2016	\$ 224,477	\$ (64,852 )	\$ 1	8,717,967	\$ 87	\$ (2 )	\$ 269,849	\$ (64,050 )	\$ 18,592
Series D preferred stock dividends (9.0% per year)	(670 )	—	—	—	—	—	(670 )	—	—
Net income (loss)	(8,091 )	(8,091 )	—	—	—	—	—	(8,469 )	378
Balance, September 30, 2017	\$ 215,716	\$ (72,943 )	\$ 1	8,717,967	\$ 87	\$ (2 )	\$ 269,179	\$ (72,519 )	\$ 18,970

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

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

	For the Nine Months Ended September 30, 2017          2016 (dollars in thousands)	
Net loss, comprehensive loss	\$ (8,091 )	\$ (3,239 )
Comprehensive income attributable to non-controlling interest	(378 )	(189 )
Comprehensive loss attributable to Transcontinental Realty Investors, Inc.	\$ (8,469 )	\$ (3,428 )

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

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

	For the Nine Months Ended September 30, 2017                  2016 (dollars in thousands)	
<b>Cash Flow From Operating Activities:</b>		
Net loss	\$ (8,091 )	\$ (3,239 )
Adjustments to reconcile net loss applicable to common shares to net cash flows from operating activities:		
Gain on sale of income-producing properties	(9,841 )	(4,925 )
Gain on sale of land	(500 )	(3,925 )
Depreciation and amortization	19,008	16,602
Amortization of deferred borrowing costs	2,872	3,164
Earnings from unconsolidated joint ventures and investees	11	2
Decrease (increase) in assets:		
Accrued interest receivable	1,044	1,224
Other assets	11,798	(895 )
Prepaid expense	(5,661 )	(3,207 )
Escrow	(3,484 )	11,537
Earnest money	1,072	449
Rent receivables	544	—
Related party receivables	(5,357 )	(852 )
Increase (decrease) in liabilities:		
Accrued interest payable	1,508	(44 )
Other liabilities	(23,180 )	1,233
Net cash provided by operating activities	(18,257 )	17,124
<b>Cash Flow From Investing Activities:</b>		
Proceeds from notes receivable	26,077	2,773
Origination or advances on notes receivable	(10,665 )	(7,150 )
Acquisition of land held for development	(11,440 )	—
Acquisition of income-producing properties	—	(41,750 )
Proceeds from sale of income-producing properties	—	9,377
Proceeds from sale of land	2,446	7,152
Investment in unconsolidated real estate entities	11	2,770
Improvement of land held for development	(908 )	(2,486 )
Improvement of income-producing properties	(4,462 )	(4,030 )
Construction and development of new properties	(41,489 )	(31,844 )
Net cash used in investing activities	(40,430 )	(65,188 )
<b>Cash Flow From Financing Activities:</b>		

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

Proceeds from Series A bonds payable	106,583	—
Proceeds from notes payable	54,231	115,031
Recurring amortization of principal on notes payable	(7,279 )	(10,480 )
Payments on maturing notes payable	(59,068 )	(60,977 )
Deferred financing costs	(820 )	(2,669 )
Bond issuance costs	6,182	—
Preferred stock dividends - Series D	(670 )	(673 )
Net cash provided by financing activities	(99,159 )	40,232
Net increase (decrease) in cash and cash equivalents	40,472	(7,832 )
Cash and cash equivalents, beginning of period	17,506	15,171
Cash and cash equivalents, end of period	\$ 57,978	\$ 7,339
Supplemental disclosures of cash flow information:		
Cash paid for interest	\$ 36,393	\$ 30,957

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 1. ORGANIZATION AND BASIS OF PRESENTATION

#### Organization

As used herein, the terms “TCI”, “the Company”, “we”, “our” or “us” refer to Transcontinental Realty Investors, Inc., a Nevada corporation which was formed in 1984. The Company is headquartered in Dallas, Texas and its common stock trades on the New York Stock Exchange (“NYSE”) under the symbol (“TCI”). Subsidiaries of American Realty Investors, Inc. (“ARL”) own approximately 80.9% of the Company’s common stock. Accordingly, TCI’s financial results are consolidated with those of ARL’s on Form 10-K and related Consolidated Financial Statements. ARL’s common stock trades on the New York Stock Exchange under the symbol (“ARL”). We have no employees.

TCI is a “C” corporation for U.S. federal income tax purposes and files an annual consolidated tax return with ARL and its ultimate parent, May Realty Holdings, Inc. (“MRHI”).

TCI owns approximately 81.1% of the common stock of Income Opportunity Realty Investors, Inc. (“IOR”). Accordingly IOR’s financial results are consolidated with those of TCI and its subsidiaries. Shares of IOR are traded on the New York Stock Exchange Euronext (“NYSE MKT”) under the symbol (“IOR”).

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

Regis Realty Prime, LLC (“Regis”) manages our commercial properties and provides brokerage services for our real estate portfolio. TCI engages third-party companies to lease and manage its apartment properties.

## Properties

We own or had interests in a total property portfolio of 58 income-producing properties as of September 30, 2017. The properties consisted of:

Seven commercial properties consisting of five office buildings and two retail centers comprising in aggregate approximately 1.7 million rentable square feet;

A golf course comprising approximately 96.09 acres;

50 apartment communities totaling 8,226 units; excluding apartments being developed; and

3,505 acres of developed and undeveloped land.

We join with various third-party development companies to construct residential apartment communities. We are in the predevelopment process on several residential apartment communities that have not yet begun construction. At September 30, 2017, we had seven apartment projects in development. The third-party developer typically holds a general partner, as well as a majority limited partner interest in a limited partnership formed for the purpose of building a single property, while we generally take a minority limited partner interest in the limited partnership. We may contribute land to the partnership as part of our equity contribution or we may contribute the necessary funds to the partnership to acquire the land. We are required to fund all necessary equity contributions while the third-party developer is responsible for obtaining construction financing, hiring a general contractor and for the overall management, successful completion and delivery of the project. We generally bear all the economic risks and rewards of ownership in these partnerships and therefore include these partnerships in our Consolidated Financial Statements. The third-party developer is paid a developer fee typically equal to a percentage of the construction costs. When the project reaches stabilized occupancy, we acquire the third-party developer’s partnership interests in exchange for any remaining unpaid developer fees.

## **Basis of Presentation**

The accompanying unaudited Consolidated Financial Statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”) have been condensed or omitted in accordance with such rules and regulations, although management believes the disclosures are adequate to prevent the information presented from being misleading. In the opinion of management, all adjustments (consisting of normal recurring matters) considered necessary for a fair presentation have been included. The results of operations for the nine months ended September 30, 2017, are not necessarily indicative of the results that may be expected for other interim periods or for the full fiscal year.

The year-end Consolidated Balance Sheet at December 31, 2016, was derived from the audited Consolidated Financial Statements at that date, but does not include all of the information and disclosures required by U.S. GAAP for complete financial statements. For further information, refer to the Consolidated Financial Statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2016. Certain 2016 Consolidated Financial Statement amounts have been reclassified to conform to the 2017 presentation.

## **Principles of Consolidation**

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

In determining whether we are the primary beneficiary of a VIE, we consider qualitative and quantitative factors, including, but not limited to: the amount and characteristics of our investment; the obligation or likelihood for us or other investors to provide financial support; our and the other investors’ ability to control or significantly influence key

decisions for the VIE; and the similarity with and significance to the business activities of us and the other investors. Significant judgments related to these determinations include estimates about the current future fair values and performance of real estate held by these VIEs and general market conditions.

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

### **Real Estate, Depreciation and Impairment**

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



### **Real Estate Held for Sale**

We periodically classify real estate assets as “held for sale.” An asset is classified as held for sale upon the approval of our Board of Directors, after an active program to sell the asset has commenced and if the sale is probable. One of the deciding factors in determining whether a sale is probable is whether the firm purchase commitment is obtained and whether the sale is probable within the year. Upon the classification of a real estate asset as held for sale, the carrying value of the asset is reduced to the lower of its net book value or its estimated fair value, less costs to sell the asset. Subsequent to the classification of assets as held for sale, no further depreciation expense is recorded. Real estate assets held for sale are stated separately on the accompanying Consolidated Balance Sheets. Upon a decision that the sale is no longer probable, the asset is classified as an operating asset and depreciation expense is reinstated.

### **Cost Capitalization**

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

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

### **Fair Value Measurement**

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

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

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

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

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

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

### **Deferred Costs**

Costs related to the financing of properties are deferred and amortized over the life of the related financing agreement. Amortization is reflected as interest expense in the Consolidated Statements of Operations, with remaining terms ranging from 6 months to 40 years. Unamortized financing costs are written off when the financing agreement is extinguished before the maturity date.

### **Related Parties**

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

## Newly Issued Accounting Pronouncements

In May 2014, Accounting Standards Update (“ASU”) No. 2014-09 (“ASU 2014-09”), “Revenue from Contracts with Customers,” was issued. This new guidance established a new single comprehensive revenue recognition model and provides for enhanced disclosures. Under the new policy, the nature, timing and amount of revenue recognized for certain transactions could differ from those recognized under existing accounting guidance. This new standard does not affect revenue recognized under lease contracts. ASU 2014-09 is effective for reporting periods beginning after December 15, 2017. The Company is currently evaluating the impact of the adoption of ASU 2014-09 on its financial position and results of operations, if any.

In February 2016, Accounting Standards Update No. 2016-02 (“ASU 2016-02”), Leases was issued. This guidance establishes a new model for accounting for leases and provides for enhanced disclosures. ASU 2016-02 is effective for reporting periods beginning after December 15, 2018. The Company is currently evaluating the impact of the adoption of ASU 2016-02 on its financial position and results of operations, if any.

## NOTE 2. REAL ESTATE ACTIVITY

Below is a summary of the real estate owned as of September 30, 2017 (dollars in thousands):

Apartments	\$699,127
Apartments under construction	77,537
Commercial properties	206,982
Land held for development	71,238
Real estate subject to sales contract	46,403
Total real estate	\$1,101,287
Less accumulated depreciation	(172,352 )
Total real estate, net of depreciation	\$928,935

The highlights of our significant real estate transactions for the nine months ended September 30, 2017, are discussed below.

### Purchases

During the nine months ended September 30, 2017, we acquired three land parcels for development for a total purchase price of \$11.4 million, adding 29.7 acres to the development portfolio.

### Sales

During the nine months ended September 30, 2017, TCI sold a combined 14.16 acres of land located in Texas to independent third parties for a total sales price of \$2.4 million. We recorded an aggregate gain of \$0.5 million from the land sales.

In addition, during the nine months ended September 30, 2017, we recognized deferred gains of \$9.8 million related to prior years' sales of two income-producing properties to a related party.

As of September 30, 2017, the Company has approximately 91 acres of land, at various locations that were sold to related parties in multiple transactions. These transactions are treated as "subject to sales contract" on the Consolidated Balance Sheets. Due to the related party nature of the transactions, TCI has deferred the recording of the sales in accordance with ASC 360-20.

We continue to invest in the development of multifamily properties. During the nine months ended September 30, 2017, we disbursed \$41.4 million related to the construction or predevelopment of various apartment complexes and capitalized \$1.6 million of interest costs.

**NOTE 3. NOTES AND INTEREST RECEIVABLE**

A portion of our assets are invested in mortgage notes receivable, principally secured by real estate. We may originate mortgage loans in conjunction with providing purchase money financing of property sales. Notes receivable are generally collateralized by real estate or interests in real estate and guarantees, unless noted otherwise, are so secured. Management intends to service and hold for investment the mortgage notes in our portfolio. A majority of the notes receivable provide for principal to be paid at maturity. Below is a summary of our notes receivable as of September 30, 2017 (dollars in thousands):

Borrower	Maturity Date	Interest Rate	Amount	Collateral
Performing loans:				
H198, LLC (Las Vegas Land)	01/20	12.00 %	5,907	Secured
H198, LLC (McKinney Ranch land)	09/18	6.00 %	4,402	Secured
Spyglass Apartments of Ennis	11/19	5.00 %	3,862	Secured
Oulan-Chikh Family Trust	03/21	8.00 %	174	Secured
Unified Housing Foundation, Inc. (Echo Station) <sup>(1)</sup>	12/32	12.00 %	1,481	Secured
(1) Unified Housing Foundation, Inc. (Lakeshore Villas)	12/32	12.00 %	2,000	Secured
(1) Unified Housing Foundation, Inc. (Lakeshore Villas)	12/32	12.00 %	6,369	Secured
(1) Unified Housing Foundation, Inc. (Limestone Ranch)	12/32	12.00 %	6,000	Secured
(1) Unified Housing Foundation, Inc. (Limestone Ranch)	12/32	12.00 %	1,953	Secured
(1) Unified Housing Foundation, Inc. (Timbers of Terrell)	12/32	12.00 %	1,323	Secured
Unified Housing Foundation, Inc. (Tivoli) <sup>(1)</sup>	12/32	12.00 %	7,965	Secured
Unified Housing Foundation, Inc. <sup>(1)</sup>	12/18	12.00 %	3,994	Unsecured
Unified Housing Foundation, Inc. <sup>(1)</sup>	12/18	12.00 %	6,407	Unsecured
Unified Housing Foundation, Inc. <sup>(1)</sup>	06/20	12.00 %	5,760	Unsecured
Other related party notes <sup>(1)</sup>	Various	Various	465	Various unsecured interests
Other non-related party notes	Various	Various	796	Various secured interests
Other non-related party notes	Various	Various	1,231	Various unsecured interests
Accrued interest			4,434	
Total Performing			\$64,523	
Allowance for estimated losses			(1,825 )	
Total			\$62,698	

(1) Related party notes.

We invest in mortgage loans, secured by mortgages that are subordinate to one or more prior liens either on the fee or a leasehold interest in real estate. Recourse on such loans ordinarily includes the real estate on which the loan is made, other collateral and guarantees.

At September 30, 2017, we had mortgage loans and accrued interest receivable from related parties, net of allowances, totaling \$43.7 million. During the nine months ended September 30, 2017, we recognized interest income of \$5.2 million from related party notes receivable.

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

**NOTE 4. INVESTMENT IN UNCONSOLIDATED JOINT VENTURES AND INVESTEEES**

Investments in unconsolidated joint ventures and other investees in which we have a 20% to 50% interest or otherwise exercise significant influence, are carried at cost and adjusted for the Company's proportionate share of their undistributed earnings or losses under the equity method of accounting. ARL is our parent company and is considered as an unconsolidated joint venture.

Investments in unconsolidated joint ventures and investees consist of the following:

	Percentage ownership as of		
	September 30, 2017	September 30, 2016	
American Realty Investors, Inc. <sup>(1)</sup>	0.90%	0.90	%

(1)  
Unconsolidated investment in parent company owning 140,000 shares of ARL Common Stock.

Our interest in the common stock of ARL in the amount of 0.90% is accounted for under the equity method because we exercise significant influence over the operations and financial activities. Accordingly, the investments are carried at cost, adjusted for the Company's proportionate share of earnings or losses.

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

As of September 30,	2017	2016
Real estate, net of accumulated depreciation	\$ 14,411	\$ 14,550
Notes receivable	39,857	46,371

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

Other assets	54,703	126,848
Notes payable	(6,618 )	(10,426 )
Other liabilities	(37,184)	(111,789)
Shareholders' equity	(65,169)	(65,554 )

For the Nine Months Ended September 30,	2017	2016
Rents and interest and other income	\$4,655	\$5,586
Depreciation	(142 )	(113 )
Operating expenses	(2,607)	(2,897)
Gain on land sales	1,360	—
Interest expense	(4,641)	(4,725)
Net loss	\$(1,375)	\$(2,149)
Company's proportionate share of loss	\$(12 )	\$(19 )



**NOTE 5. NOTES PAYABLE**

Below is a summary of our notes and interest payable as of September 30, 2017 (dollars in thousands):

	Notes Payable	Accrued Interest	Total Debt
Apartments	\$537,396	\$ 1,476	\$538,872
Apartments under Construction	43,507	—	43,507
Commercial	127,182	602	127,784
Land	24,712	230	24,942
Real estate subject to sales contract	3,450	489	3,939
Mezzanine financing	100,673	—	100,673
Other	9,037	—	9,037
Total	\$845,957	\$ 2,797	\$848,754
Unamortized deferred borrowing costs	(18,389 )	—	(18,389 )
Total	\$827,568	\$ 2,797	\$830,365

The segment labeled as “Other” consists of unsecured or stock-secured notes payable.

There are various land mortgages, secured by the property, that are in the process of a modification or extension to the original note due to expiration of the loan. We are in constant contact with these lenders, working together in order to modify the terms of these loans and we anticipate a timely resolution that is similar to the existing agreement or subsequent modification. During the nine months ended September 30, 2017, we refinanced three loans with a total principal balance of \$80.1 million. The transactions provided for lower monthly payments over the term of the loans due to lower interest rates and the extension of maturity dates of the loans.

In conjunction with the development of various apartment projects and other developments, we drew down \$25.7 million in construction loans during the nine months ended September 30, 2017.

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

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

#### **NOTE 6. SERIES A BONDS PAYABLE**

On February 13, 2017, Southern Properties Capital LTD, a British Virgin Islands corporation (“Southern”), filed a final prospectus with the Tel Aviv Stock Exchange LTD (the “TASE”) for an offering and sale of nonconvertible Series A Bonds (the “Debentures”), to be issued by Southern, which is an indirect subsidiary of TCI. Southern, in turn, wholly owns interest in other entities, which, in turn, are the principal owners of various residential and commercial properties located in the south and southwestern portions of the United States. The Debentures are unsecured obligations of Southern. On February 14, 2017, Southern commenced the institutional tender of the Debentures and accepted application for 276 million Israeli, new Shekels (approximately \$73,651,065 USD, based on the exchange rate of 3.7474 Shekels to the U.S. Dollar effective February 14, 2017) in both institutional and public tenders, at an annual interest rate averaging approximately 7.38%. The Series A Bonds payable have a stated interest rate of 7.3% and an effective yield of 9.25%.

On May 16, 2017, Southern issued nonconvertible Series A Bonds for 100.2 million Israelis, new Shekels (approximately \$27,769,615 USD, based on the exchange rate of 3.607 Shekels to the U.S. Dollar) at an annual interest rate of 7.3%.

On July 12, 2017, Southern sold nonconvertible Series A Bonds for 23.8 million Israeli, new Shekels (approximately \$6,668,998 USD, based on the exchange rate of 3.574 Shekels to the U.S. Dollar) in both institutional and public tenders, at an annual interest rate averaging approximately 7.3%.

**Foreign Currency Gain or Loss**

Principal and interest will be paid in Israeli Shekels as the bonds mature. Interest payments are due semiannually beginning in July 2017 through July 2023 with ten semiannual principal payments due beginning July 2019 through July 2023. Until such actual principal payments are made, there will not be any significant need to convert US dollars to Israeli shekels.

The Company records unrealized gains or losses each quarter based upon the relative exchange values of the US dollar and the Israeli shekel; however, no gain or loss will be realized until a conversion from US dollars to Israeli shekels actually occurs in the future. The recorded unrealized gain or loss is reflected as a separate line item to highlight the fact that it is a non-cash transaction until such time as actual payment of principal and interest on the bonds is made.

The Company recorded a foreign currency transaction gain of \$1.9 million and a foreign currency transaction loss of \$1.8 million for the three and nine months ended September 30, 2017, respectively.

**NOTE 7. RELATED PARTY TRANSACTIONS**

The following table reflects the reconciliation of the beginning and ending balances of accounts receivable from and (accounts payable) to related parties as of September 30, 2017 (dollars in thousands):

	Pillar	ARL	Total
Related party receivable, December 31, 2016	\$(7,103 )	\$108,752	\$101,649
Cash transfers	31,933	—	31,933
Advisory fees	(7,402 )	—	(7,402 )
Net income fee	(189 )	—	(189 )
Fees and commissions	(1,658 )	—	(1,658 )
Cost reimbursements	(1,954 )	—	(1,954 )
Interest income	—	3,462	3,462
Notes receivable purchased	(447 )	—	(447 )
Expenses paid by advisor	(3,913 )	—	(3,913 )
Financing (mortgage payments)	(4,656 )	—	(4,656 )
Sales/Purchases transactions	(9,129 )	—	(9,129 )
Purchase of obligations	5,208	(5,208 )	—
Related party receivable, Sept 30, 2017	\$690	\$107,006	\$107,696

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

#### **NOTE 8. OPERATING SEGMENTS**

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

Items of income that are not reflected in the segments are other income and equity in partnerships. Expenses that are not reflected in the segments are provision for losses, advisory and net income fees, general and administrative and non-controlling interests.

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

Presented below is our reportable segments' operating income for the three months ended September 30, 2017 and 2016, including capital expenditures and segment assets (dollars in thousands):

For the Three Months Ended September 30, 2017	Commercial Properties	Apartments	Land	Other	Total
Rental and other property revenues	\$ 8,170	\$ 23,231	\$ 86	\$ 4	\$ 31,491
Property operating expenses	(4,252 )	(10,659 )	(115 )	(131 )	(15,157 )
Depreciation and amortization	(2,298 )	(4,028 )	—	—	(6,326 )
Mortgage and loan interest	(1,902 )	(5,168 )	(387 )	(6,788)	(14,245 )
Interest income	—	—	—	3,175	3,175
Recognition of deferred gain on sale of income-producing properties	—	9,841	—	—	9,841
Gain on land sales	—	—	530	—	530
Segment operating income (loss)	\$ (282 )	\$ 13,217	\$ 114	\$ (3,740)	\$ 9,309

Balance Sheet Data as of September 30, 2017

Capital expenditures	\$ 689	\$ 543	\$ 55	\$ —	\$ 1,287
Real estate assets	\$ 145,321	\$ 665,972	\$ 117,642	\$ —	\$ 928,935

Property Sales

Sales price	\$ —	\$ —	\$ 850	\$ —	\$ 850
Cost of sale	—	—	(320 )	—	(320 )
Recognized prior deferred gain	—	9,841	—	—	9,841
Gain on sale	\$ —	\$ 9,841	\$ 530	\$ —	\$ 10,371

For the Three Months Ended September 30, 2016

	Commercial Properties	Apartments	Land	Other	Total
Rental and other property revenues	\$ 7,368	\$ 22,408	\$ —	\$ —	\$ 29,776
Property operating expenses	(4,500 )	(10,696 )	(209 )	(8 )	(15,413 )
Depreciation and amortization	(2,207 )	(3,807 )	—	—	(6,014 )
Mortgage and loan interest	(1,700 )	(6,424 )	(420 )	(5,024)	(13,568 )
Interest income	—	—	—	4,251	4,251
Gain on land sales	—	—	555	—	555
Segment operating income (loss)	\$ (1,039 )	\$ 1,481	\$ (74 )	\$ (781 )	\$ (413 )

Balance Sheet Data as of September 30, 2016

Capital expenditures	\$ 3,700	\$ (146 )	\$ 1,873	\$ —	\$ 5,427
Real estate assets	\$ 149,705	\$ 615,822	\$ 134,321	\$ —	\$ 899,848

Property Sales

Sales price	\$ —	\$ —	\$ 805	\$ —	\$ 805
Cost of sale	—	—	(250 )	—	(250 )

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

Gain on sale	\$ —	\$ —	\$555	\$—	\$555
--------------	------	------	-------	-----	-------

The table below reflects the reconciliation of segment information to the corresponding amounts in the Consolidated Statements of Operations for the three months ended September 30, 2017 and 2016 (dollars in thousands):

	Three Months Ended September 30,	
	2017	2016
Segment operating income (loss)	\$9,309	\$(413 )
Other non-segment items of income (expense):		
General and administrative	(1,594)	(1,541)
Net income fee to related party	(53 )	(67 )
Advisory fee to related party	(2,595)	(2,394)
Other income	2,096	8
Earnings from unconsolidated joint ventures and investees	7	—
Income tax expense	—	(25 )
Net income (loss) from continuing operations	\$7,170	\$(4,432)

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

Presented below is our reportable segments' operating income for the nine months ended September 30, 2017 and 2016, including capital expenditures and segment assets (dollars in thousands):

For the Nine Months Ended September 30, 2017	Commercial Properties	Apartments	Land	Other	Total
Rental and other property revenues	\$ 25,308	\$ 68,922	\$ 87	\$ 11	\$ 94,328
Property operating expenses	(13,629 )	(31,615 )	(429 )	(583 )	(46,256 )
Depreciation and amortization	(6,903 )	(12,105 )	—	—	(19,008 )
Mortgage and loan interest	(5,629 )	(16,955 )	(1,248 )	(21,386)	(45,218 )
Interest income	—	—	—	10,305	10,305
Recognition of deferred gain on sale of income-producing properties	—	9,841	—	—	9,841
Gain on land sales	—	—	500	—	500
Segment operating income (loss)	\$ (853 )	\$ 18,088	\$ (1,090 )	\$ (11,653)	\$ 4,492

Balance Sheet as of September 30, 2017

Capital expenditures	\$ 2,586	\$ 543	\$ 641	\$ —	\$ 3,770
Real estate assets	\$ 145,321	\$ 665,972	\$ 117,642	\$ —	\$ 928,935

Property Sales

Sales price	\$ —	\$ —	\$ 2,446	\$ —	\$ 2,446
Cost of sale	—	—	(1,946 )	—	(1,946 )
Recognized prior deferred gain	—	9,841	—	—	9,841
Gain on sale	\$ —	\$ 9,841	\$ 500	\$ —	\$ 10,341

For the Nine Months Ended September 30, 2016

Commercial Properties	Apartments	Land	Other	Total	
Rental and other property revenues	\$ 23,620	\$ 65,578	\$ —	\$ 2	\$ 89,200
Property operating expenses	(13,953 )	(30,258 )	(1,079 )	(5 )	(45,295 )
Depreciation and amortization	(6,707 )	(10,958 )	—	—	(17,665 )
Mortgage and loan interest	(5,347 )	(18,689 )	(1,335 )	(13,455)	(38,826 )
Interest income	—	—	—	11,386	11,386
Gain on sale of income producing properties	(243 )	5,168	—	—	4,925
Gain on land sales	—	—	3,925	—	3,925
Segment operating income (loss)	\$ (2,630 )	\$ 10,841	\$ 1,511	\$ (2,072 )	\$ 7,650

Balance Sheet as of September 30, 2016

Capital expenditures	\$ 3,700	\$ (146 )	\$ 1,873	\$ —	\$ 5,427
Real estate assets	\$ 149,705	\$ 615,822	\$ 134,321	\$ —	\$ 899,848

Property Sales

Sales price	\$ 1,500	\$ 8,100	\$ 8,139	\$ —	\$ 17,739
Cost of sale	(1,743 )	(2,932 )	(4,214 )	—	(8,889 )
Gain on sale	\$ (243 )	\$ 5,168	\$ 3,925	\$ —	\$ 8,850

The table below reflects the reconciliation of segment information to the corresponding amounts in the Consolidated Statements of Operations for the nine months ended September 30, 2017 and 2016 (dollars in thousands):

	Nine Months Ended September 30,	
	2017	2016
Segment operating income	\$4,492	\$7,650
Other non-segment items of income (expense)		
General and administrative	(4,669)	(4,754)
Net income fee to related party	(189 )	(193 )
Advisory fee to related party	(7,402)	(7,096)
Other income	(312 )	1,178
Loss from unconsolidated joint ventures and investees	(11 )	(2 )
Income tax expense	—	(24 )
Net loss from continuing operations	\$ (8,091)	\$ (3,241)



The table below reflects the reconciliation of segment information to the corresponding amounts in the Consolidated Balance Sheets (dollars in thousands):

	As of September 30,	
	2017	2016
Segment assets	\$928,935	\$899,848
Investments in real estate partnerships	2,435	2,469
Notes and interest receivable	62,698	72,704
Other assets	256,659	176,527
Total assets	\$1,250,727	\$1,151,548

## NOTE 9. COMMITMENTS AND CONTINGENCIES AND LIQUIDITY

*Liquidity.* Management believes that TCI will generate excess cash from property operations in 2017; such excess, however, will not be sufficient to discharge all of TCI's obligations as they become due. Management intends to sell land and income-producing real estate, refinance real estate and obtain additional borrowings primarily secured by real estate to meet its liquidity requirements.

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

### **Dynex Capital, Inc.**

On July 20, 2015, the 68<sup>th</sup> Judicial District Court in Dallas County, Texas issued its Final Judgment in Cause No. DC-03-00675, styled Basic Capital Management, Inc., American Realty Trust, Inc., Transcontinental Realty Investors, Inc., Continental Poydras Corp., Continental Common, Inc. and Continental Baronne, Inc. v. Dynex Commercial, Inc. The case, which was litigated for more than a decade, had its origin with Dynex Commercial making loans to Continental Poydras Corp., Continental Common, Inc. and Continental Baronne, Inc. (subsidiaries of Continental Mortgage & Equity Trust ("CMET")), an entity which merged into TCI in 1999 after the original suit was filed). Under the original loan commitment, \$160 million in loans were to be made to the entities. The loans were conditioned on the execution of a commitment between Dynex Commercial and Basic Capital Management, Inc. ("Basic").

An original trial in 2004, which also included Dynex Capital, Inc. as a defendant, resulted in a jury awarding damages in favor of Basic for “lost opportunity,” as well as damages in favor of ART and in favor of TCI and its subsidiaries for “increased costs” and “lost opportunity.” The original Trial Court judge ignored the jury’s findings, however, and entered a “Judgment Notwithstanding the Verdict” (“JNOV”) in favor of the Dynex entities (the judge held the Plaintiffs were not entitled to any damages from the Dynex entities). After numerous appeals by all parties, Dynex Capital, Inc. was ultimately dismissed from the case and the remaining claims against Dynex Commercial were remanded to the Trial Court for a new judgment consistent with the jury’s findings. The Court entered the new Final Judgment against Dynex Commercial, Inc. on July 20, 2015.

The Final Judgment entered against Dynex Commercial, Inc. on July 20, 2015 awarded Basic \$0.256 million in damages, plus pre-judgment interest of \$0.192 million for a total amount of \$0.448 million. The Judgment awarded ART \$14.2 million in damages, plus pre-judgment interest of \$10.6 million for a total amount of \$24.8 million. The Judgment awarded TCI \$11.1 million, plus pre-judgment interest of \$8.4 million for a total amount of \$19.5 million. The Judgment also awarded Basic, ART, and TCI post-judgment interest at the rate of 5% per annum from April 25, 2014 until the date their respective damages are paid. Lastly, the Judgement awarded Basic, ART, and TCI \$1.6 million collectively in attorneys’ fees from Dynex Commercial, Inc.

In April 2017, the plaintiffs filed a lawsuit against Dynex Capital, Inc. and Dynex Commercial, Inc. for \$50 million alleging, among other things, fraudulent transfer and alter ego.

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

*Guarantees.* The Company is the primary guarantor on a \$60.4 million mezzanine loan between UHF and a lender. In addition, ARI and an officer of the Company are limited recourse guarantors of the loan. As of September 30, 2017, UHF was in compliance with the covenants to the loan agreement.

#### **NOTE 10. EARNINGS PER SHARE**

Earnings per Share ("EPS") have been computed pursuant to the provisions of ASC 260 "Earnings per Share". The computation of basic EPS is calculated by dividing income available to common shareholders by the weighted-average number of common shares outstanding during the period. Shares issued during the period shall be weighted for the portion of the period that they were outstanding.

Prior to July 9, 2014, TCI had 30,000 shares of Series C cumulative convertible preferred stock issued and outstanding. These 30,000 shares were owned by RAI, a related party, and had accrued dividends unpaid of \$0.9 million. The stock had a liquidation preference of \$100.00 per share and could be converted into common stock at 90% of the daily average closing price of the common stock for the prior five trading days. On July 9, 2014, RAI converted all 30,000 shares into the requisite number of shares of common stock. The conversion resulted in the issuance of 304,298 new shares of common stock. The effects of the Series C Cumulative Convertible Preferred Stock are no longer included in the dilutive earnings per share calculation for the current period, but are considered in the calculation for the prior periods if applying the if-converted method is dilutive.

As of September 30, 2017, the Company has no preferred stock or stock options that are required to be included in the calculation of EPS.

#### **NOTE 11. SUBSEQUENT EVENTS**

The date to which events occurring after September 30, 2017, the date of the most recent balance sheet, have been evaluated for possible adjustment to the Consolidated Financial Statements or disclosure is November 14, 2017, which is the date on which the Consolidated Financial Statements were available to be issued.

The Company has determined that there are no subsequent events to be reported.

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

The following discussion should be read in conjunction with the Consolidated Financial Statements and notes thereto appearing elsewhere in this report.

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

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

general risks affecting the real estate industry (including, without limitation, the inability to enter into or renew leases, dependence on tenants' financial condition, and competition from other developers, owners and operators of real estate);

risks associated with the availability and terms of construction and mortgage financing and the use of debt to fund acquisitions and developments;

demand for apartments and commercial properties in the Company's markets and the effect on occupancy and rental rates;

the Company's ability to obtain financing, enter into joint venture arrangements in relation to or self-fund the development or acquisition of properties;

risks associated with the timing and amount of property sales and the resulting gains/losses associated with such sales;

failure to manage effectively our growth and expansion into new markets or to integrate acquisitions successfully;

risks and uncertainties affecting property development and construction (including, without limitation, construction delays, cost overruns, inability to obtain necessary permits and public opposition to such activities);

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

costs of compliance with the Americans with Disabilities Act and other similar laws and regulations;

potential liability for uninsured losses and environmental contamination;

risks associated with our dependence on key personnel whose continued service is not guaranteed; and

the other risk factors identified in this Form 10-Q, including those described under the caption “Risk Factors.”

The risks included here are not exhaustive. Some of the risks and uncertainties that may cause our actual results, performance, or achievements to differ materially from those expressed or implied by forward-looking statements, include among others, the factors listed and described at Part I, Item 1A. “Risk Factors” in the Company’s Annual Report on Form 10-K, which investors should review. There have been no changes from the risk factors previously described in the Company’s Form 10-K for the fiscal year ended December 31, 2016.

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

## **Overview**

We are an externally advised and managed real estate investment company that owns a diverse portfolio of income-producing properties and land held for development. Our portfolio of income-producing properties includes residential apartment communities, office buildings and other commercial properties. Our investment strategy includes acquiring existing income-producing properties, as well as developing new properties on land already owned or acquired for a specific development project. We acquire land primarily in urban in-fill locations or high-growth suburban markets. We are an active buyer and seller of real estate.

During the nine months ended September 30, 2017, we sold 14.16 acres of land for an aggregate sales price of \$2.4 million and acquired three land parcels for development with a combined total of 29.7 acres for a total purchase price of \$11.4 million.

As of September 30, 2017, we owned 8,226 units in 50 residential apartment communities, 7 commercial properties comprising approximately 1.7 million rentable square feet and a golf course. In addition, we own 3,505 acres of land held for development. The Company currently owns income-producing properties and land in ten states as well as in the U.S. Virgin Islands.

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

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

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

Regis Realty Prime, LLC ("Regis") manages our commercial properties and provides brokerage services for our real estate portfolio. TCI engages third-party companies to lease and manage its apartment properties.

### **Critical Accounting Policies**

We present our Consolidated Financial Statements in accordance with generally accepted accounting principles in the United States of America ("U.S. GAAP"). The FASB Accounting Standards Codification ("ASC") is the single source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with U.S. GAAP.

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

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

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



## **Real Estate**

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

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

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

## **Depreciation and Impairment**

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

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

### **Investments in Unconsolidated Real Estate Ventures**

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

### **Recognition of Rental Income**

Rental income for commercial property leases is recognized on a straight-line basis over the respective lease terms. On our Consolidated Balance Sheets, we include as a receivable the excess of rental income recognized over rental payments actually received pursuant to the terms of the individual commercial lease agreements.

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

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

### **Revenue Recognition on the Sale of Real Estate**

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

### **Non-Performing Notes Receivable**

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

### **Interest Recognition on Notes Receivable**

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

### **Allowance for Estimated Losses**

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

### **Fair Value of Financial Instruments**

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

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

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

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

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

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

### **Related Parties**

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

### **Foreign Currency Gain or Loss**

A subsidiary of TCI issued \$106.6 million in bonds during 2017 that will be repaid in Israeli Shekels as the bonds mature. Interest payments are due semiannually beginning in July 2017 through July 2023 with ten semiannual principal payments due beginning July 2019 through July 2023. Until such actual principal payments are made, there will not be any significant need to convert US dollars to Israeli shekels.

The Company records unrealized gains or losses each quarter based upon the relative exchange values of the US dollar and the Israeli shekel; however, no gain or loss will be realized until a conversion from US dollars to Israeli shekels actually occurs in the future. The recorded unrealized gain or loss is reflected as a separate line item to highlight the fact that it is a non-cash transaction until such time as actual payment of principal and interest on the bonds is made.

The Company recorded a foreign currency transaction gain of \$1.9 million and a foreign currency transaction loss of \$1.8 million for the three and nine months ended September 30, 2017, respectively.

### **Results of Operations**

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

The following discussion is based on our Consolidated Statements of Operations for the three and nine months ended September 30, 2017 and 2016, as included in Part I, Item 1. "Financial Statements" of this report. At September 30, 2017 and 2016, we owned or had interests in a portfolio of 58 and 56 income-producing properties, respectively.

***Comparison of the three months ended September 30, 2017 to the same period ended 2016:***

For the three months ended September 30, 2017, we reported net income applicable to common shares of \$6.9 million or \$0.79 income per diluted share, compared to a net loss applicable to common shares of \$4.8 million or \$0.55 loss per diluted share for the same period in 2016.

## Revenues

Rental and other property revenues were \$31.5 million for the three months ended September 30, 2017. This represents an increase of \$1.7 million compared to the prior period revenues of \$29.8 million. The change by segment is an increase of \$0.8 million in each of the apartment and commercial portfolios and an increase of \$0.1 million in the land portfolio. We purchased three and sold one multifamily property over the prior year which resulted in a net increase of 103 units and was the primary reason for the increase in revenues for our apartment portfolio.

## Expense

Property operating expenses were \$15.2 million for the three months ended September 30, 2017. This represents a decrease of \$0.2 million compared to the prior period operating expenses of \$15.4 million. The change by segment was decreases of \$0.2 million and \$0.1 million in the commercial and land portfolios, respectively; partially offset by an increase of \$0.1 million in the other portfolio.

Depreciation and amortization expense was \$6.3 million for the three months ended September 30, 2017 for an increase of \$0.3 million compared to the prior period expense of \$6.0 million. The increase is primarily attributable to the acquired apartment properties.

## Other income (expense)

Interest income decreased to \$3.2 million for the three months ended September 30, 2017 compared to \$4.3 million for the same period of 2016. The decrease of \$1.1 million was due primarily to the payoff, during 2017, of notes receivable related to three income-producing properties sold in a prior year.

Mortgage and loan interest expense was \$14.2 million for the three months ended September 30, 2017. This represents an increase of \$0.7 million compared to the prior period expense of \$13.6 million. Interest expense for our corporate loans increased \$1.8 million, primarily due to interest expense related to the Israeli Series A Bonds payable of \$2.6 million for the third quarter of 2017, partially offset by a decrease of \$0.6 million in interest expense as a result of a \$17.8 million pay down on a corporate loan at the end of the second quarter of 2017. We also had an increase of \$0.2 million in our commercial portfolio, due to securing additional debt obligation with the refinancing of one of our commercial loans. These increases were partially offset by a decrease of \$1.3 million in interest expense on our apartment portfolio, due to a loan prepayment penalty paid in the third quarter of 2016 for refinancing of a loan.

A subsidiary of the Company issued \$106.6 million in bonds during 2017 that will be repaid in Israeli Shekels as the bonds mature. During the three months ended September 30, 2017, the Company recorded an unrealized foreign currency transaction gain of \$1.9 million based upon the relative exchange values of the US dollar and the Israeli shekel as applied to the bond principal and accrued interest at quarter-end. We did not have any unrealized foreign currency transaction gain or loss during the three months ended September 30, 2016.

Gain on sale of income-producing properties was \$9.8 million for the three months ended September 30, 2017, due to recognition of deferred gain from property sales of two apartment communities in a prior year. There were no sales of income-producing properties during the three months ended September 30, 2017 and 2016.

Gain on land sales was \$0.5 million during the three months ended September 30, 2017 compared to \$0.6 million for the three months ended September 30, 2016. In the current period, we sold 3.3 acres of land for a total sales price of \$0.9 million and recorded a gain of \$0.5 million. During the same period of 2016, we sold 4.8 acres of land for a sales price of \$0.8 million and recorded a gain of \$0.6 million.

***Comparison of the nine months ended September 30, 2017 to the same period ended 2016:***

For the nine months ended September 30, 2017, we reported a net loss applicable to common shares of \$9.1 million or \$1.05 loss per diluted share compared to a net loss applicable to common shares of \$4.1 million or \$0.47 loss per diluted share for the same period in 2016.

**Revenues**

Rental and other property revenues were \$94.3 million for the nine months ended September 30, 2017. This represents an increase of approximately \$5.1 million compared to the prior period revenues of \$89.2 million. The change by segment is an increase in the apartment portfolio of \$3.3 million, an increase in the commercial portfolio of approximately \$1.7 million, and an increase in the land portfolio of \$0.1 million. We purchased four and sold two multifamily properties over the prior year which resulted in a net increase of 203 units and was the primary reason for the increase in our apartment portfolio revenues. The \$1.7 million increase in revenues for the commercial portfolio was primarily due to increased occupancy for two commercial properties.



## Expense

Property operating expenses were \$46.3 million for the nine months ended September 30, 2017. This represents an increase of \$1 million compared to the prior period operating expenses of \$45.3 million. The growth in our apartment portfolio resulted in a \$1.4 million increase in property operating expenses. In addition, property operating expenses for our other portfolio increased \$0.6 million due to professional fees. These increases were partially offset by decreases of \$0.7 million and \$0.3 million in our land and commercial land portfolios, respectively.

Depreciation and amortization expense was \$19 million for the nine months ended September 30, 2017. This represents an increase of \$1.3 million compared to the prior period expense of \$17.7 million. The increase is primarily due to the growth in our apartment portfolio. The increase by segment consisted of a \$1.1 million increase in the apartment portfolio and a \$0.2 million increase in the commercial portfolio.

## Other income (expense)

Interest income was \$10.3 million for the nine months ended September 30, 2017 compared to \$11.4 million for the same period of 2016. The decrease of \$1.1 million was due primarily to the payoff, during 2017, of notes receivable related to three income-producing properties sold in a prior year.

Mortgage and loan interest expense was \$45.2 million for the nine months ended September 30, 2017. This represents an increase of \$6.4 million compared to the prior period expense of \$38.8 million. The change by segment is an increase in the other portfolio of \$7.9 million primarily due to \$5.8 million interest related to our Israeli Series A Bonds, an increase of \$1.4 million on two other corporate loans closed during 2016 and an increase in loan fee expense of \$0.7 million due to the prepayment of one of our corporate loans in the second quarter of 2017. We also had an increase in our commercial portfolio of \$0.3 million, due to securing additional debt obligation and refinancing of one of our commercial loans. These increases were partially offset by decreases of \$1.7 million and \$0.1 million in the apartment and land portfolios, respectively. The decrease of interest expense in the apartment portfolio is primarily due to loan prepayment penalties associated with refinancing of loans during 2016. These refinances resulted in lower interest rates and the extension of the term of the loan.

During the nine months ended September 30, 2017, the Company recorded an unrealized foreign currency transaction loss of \$1.8 million based upon the relative exchange values of the US dollar and the Israeli shekel as applied to the Series A Bonds payable principal and accrued interest at quarter-end. We did not have any unrealized foreign currency transaction gain or loss during the nine months ended September 30, 2016.

Gain on sale of income-producing properties was \$9.8 million for the nine months ended September 30, 2017 compared to a gain of \$4.9 million for the same period of 2016. During 2017, the Company recognized \$9.8 million of deferred gain from two apartment properties sold to a related party in prior years. During the nine months ended September 30, 2016, the Company sold one apartment community located in Irving, Texas to an independent third party for a total sales price of \$8.1 million which resulted in a gain of \$5.2 million. We also sold an industrial warehouse in 2016 consisting of approximately 177,805 square feet. This sale resulted in a loss of approximately \$0.2 million.

Gain on land sales was \$0.5 million for the nine months ended September 30, 2017 compared to \$3.9 million for the comparable prior year period. During 2017, the Company sold a combined 14.2 acres of land located in Texas to independent third parties for a total sales price of \$2.4 million and a gain of \$0.5 million. In the prior period, we sold a combined 57.8 acres of land located in Texas to independent third parties for a total sales price of \$8.1 million and recorded total gain of \$3.9 million.

## **Liquidity and Capital Resources**

### **Our principal liquidity needs are:**

fund normal recurring expenses;

meet debt service and principal repayment obligations including balloon payments on maturing debt;

fund capital expenditures, including tenant improvements and leasing costs;

fund development costs not covered under construction loans; and

fund possible property acquisitions.

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

property operations;

proceeds from land and income-producing property sales;

collection of mortgage notes receivable;

collection of receivables from related party companies;

refinancing of existing debt; and

additional borrowing, including mortgage notes, mezzanine financing and lines of credit.

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

**Cash Flow Summary**

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

	Nine Months Ended September 30,		Incr / (Decr)
	2017	2016	
Net cash (used in) provided by operating activities	\$(18,257)	\$17,124	\$(35,381)

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

Net cash used in investing activities	(40,430)	(65,188)	24,758
Net cash provided by financing activities	99,159	40,232	58,927

Our primary use of cash for operations is daily operating costs, general and administrative expenses, advisory fees, and land holding costs. Our primary source of cash from operating activities is from rental income on properties. In addition, we have a related party account in which excess cash is transferred to or from.

Our primary cash outlays for investing activities are for construction and development, acquisition of land and income-producing properties, and capital improvements to existing properties. During the nine months ended September 30, 2017, we acquired three land parcels for development for a total purchase price of \$11.4 million, adding 29.7 acres to the development portfolio. During the nine months ended September 30, 2016, we purchased two apartment communities for an aggregate purchase price of \$40 million and three land parcels for future development for a total purchase price of \$8.9 million, adding 31.04 acres to the development portfolio.

Our primary sources of cash from investing activities are from the proceeds on the sale of land and income-producing properties. During the nine months ended September 30, 2017, we received aggregate sales proceeds of approximately \$1 million from the sale of 14.16 acres of land. During the nine months ended September 30, 2016, we received aggregate sales proceeds of \$15.9 million from the sale of an apartment community, an industrial warehouse and a combined 57.8 acres of land.

Our primary sources of cash from financing activities are from proceeds on notes payables either through refinancing our existing loans or by obtaining new financing. Our primary cash outlays are for recurring debt payments and payments on maturing notes payable. During the nine months ended September 30, 2017, we had a \$106.6 million increase in cash flow from financing activities as a result of proceeds received from the sale of nonconvertible Series A Bonds by Southern Properties Capital LTD, a British Virgin Islands corporation, which is an indirect subsidiary of TCI.

## **Environmental Matters**

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

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

## **Inflation**

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

## **Tax Matters**

TCI is a member of the May Realty Holdings, Inc. consolidated group for federal income tax reporting. There is a tax sharing and compensating agreement between American Realty Investors, Inc., Income Opportunity Realty Investors, Inc. and TCI.

Financial statement income varies from taxable income principally due to the accounting for income and losses of investees, gains and losses from asset sales, depreciation on owned properties, amortization of discounts on notes receivable and payable and the difference in the allowance for estimated losses. TCI had a loss for federal income tax purposes in the first nine months of 2017, and net operating losses in 2016 and 2015; therefore, it recorded no provision for income taxes.

At September 30, 2017, TCI had a net deferred tax asset of \$27.4 million due to tax deductions available to the Company in future years. However, as management cannot determine that it is more likely than not that TCI will realize the benefit of the deferred tax assets, a 100% valuation allowance has been established.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS**

We may be exposed to interest rate changes primarily as a result of long-term debt used to acquire properties and make loans and other permitted investments. Our management's objectives, with regard to interest rate risks, are to limit the impact of interest rate changes on earnings and cash flows and to lower overall borrowing costs. To achieve these objectives, we will borrow primarily at fixed rates or variable rates with the lowest margins available and in some cases, with the ability to convert variable rates to fixed rates. Of our \$830.3 million in notes payable at September 30, 2017, \$34.4 million represented debt subject to variable interest rates. If our variable interest rates increased 100 basis points, we estimate that total annual interest cost, including interest expensed and interest capitalized, would increase by \$0.4 million, and would result in a decrease of \$0.04 in our earnings per share.

Our variable rate exposure is mitigated through the ability to secure long-term fixed rate HUD financing on the residential apartment complexes with a weighted average borrowing rate of 3.72% at September 30, 2017.

### **ITEM 4. CONTROLS AND PROCEDURES**

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

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

## **PART II. OTHER INFORMATION**

### **ITEM 5. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

In December 1989, the Board of Directors approved a share repurchase program, authorizing the repurchase of a total of 687,000 shares of TCI's common stock. In June 2000, the Board increased this authorization to 1,387,000 shares. On August 10, 2010, the Board of Directors approved an increase in the share repurchase program for up to an additional 250,000 shares of common stock which results in a total authorization under the repurchase program for up to 1,637,000 shares of our common stock. This repurchase program has no termination date. There were no shares purchased under this program during the third quarter of 2017. As of September 30, 2017, 1,230,535 shares have been purchased and 406,465 shares may be purchased under the program.

**ITEM 6. EXHIBITS**

The following exhibits are filed with this report or incorporated by reference as indicated;

<b>Exhibit Number</b>	<b>Description</b>
3.0	Articles of Incorporation of Transcontinental Realty Investors, Inc., (incorporated by reference to Exhibit No. 3.1 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1991).
<u>3.1</u>	Certificate of Amendment to the Articles of Incorporation of Transcontinental Realty Investors, Inc., (incorporated by reference to the Registrant's Current Report on Form 8-K, dated June 3, 1996).
<u>3.2</u>	Certificate of Amendment of Articles of Incorporation of Transcontinental Realty Investors, Inc., dated October 10, 2000 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2000).
<u>3.3</u>	Articles of Amendment to the Articles of Incorporation of Transcontinental Realty Investors, Inc., setting forth the Certificate of Designations, Preferences and Rights of Series A Cumulative Convertible Preferred Stock, dated October 20, 1998 (incorporated by reference to Exhibit 3.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 1998).
<u>3.4</u>	Certificate of Designation of Transcontinental Realty Investors, Inc., setting forth the Voting Powers, Designations, References, Limitations, Restriction and Relative Rights of Series B Cumulative Convertible Preferred Stock, dated October 23, 2000 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2000).
<u>3.5</u>	Certificate of Designation of Transcontinental Realty Investors, Inc., setting forth the Voting Powers, Designating, Preferences, Limitations, Restrictions and Relative Rights of Series C Cumulative Convertible Preferred Stock, dated September 28, 2001 (incorporated by reference to Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2001).
<u>3.6</u>	Articles of Amendment to the Articles of Incorporation of Transcontinental Realty Investors, Inc., Decreasing the Number of Authorized Shares of and Eliminating Series B Preferred Stock dated December 14, 2001 (incorporated by reference to Exhibit 3.7 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2001).
3.7	By-Laws of Transcontinental Realty Investors, Inc. (incorporated by reference to Exhibit No. 3.2 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1991).
<u>3.8</u>	Certificate of Designation of Transcontinental Realty Investors, Inc., setting forth the Voting Powers, Designations, Preferences, Limitations, Restrictions and Relative Rights of Series D Cumulative Preferred Stock filed August 14, 2006 with the Secretary of State of Nevada (incorporated by reference to Registrant's Current Report on Form 8-K for event dated November 21, 2006 at Exhibit 3.8 thereof).



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

10.1 Advisory Agreement dated as of April 30, 2011, between Transcontinental Realty Investors, Inc., and Pillar Income Asset Management, Inc. (incorporated by reference to Exhibit 10.1 to the registrant's current report on Form 8-K for event occurring May 2, 2011).

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

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

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

101.INS XBRL Instance Document

101.SCH XBRL Taxonomy Extension Schema Document

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document

101.LAB XBRL Taxonomy Extension Label Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

\*Filed herewith.

## SIGNATURES

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

### TRANSCONTINENTAL REALTY INVESTORS, INC.

Date: November 14, 2017 By: /s/ Daniel J. Moos  
Daniel J. Moos  
President and Chief Executive Officer

*(Principal Executive Officer)*

Date: November 14, 2017 By: /s/ Gene S. Bertcher  
Gene S. Bertcher  
Executive Vice President and Chief Financial Officer

*(Principal Financial Officer)*