Meritage Homes CORP
Form 10-K
February 24, 2012
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2011

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 1-9977

(Exact Name of Registrant as Specified in its Charter)

Maryland	**86-0611231**
(State or Other Jurisdiction of	**(IRS Employer**
Incorporation or Organization)	**Identification No.)**

17851 North 85th Street, Suite 300,

Scottsdale, Arizona	**85255**
(Address of Principal Executive Offices)	**(Zip Code)**

(480) 515-8100

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	**Name of Each Exchange on which Registered**
Common Stock, $.01 par value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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

Indicate by check mark whether the registrant 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 x No ¨

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

Indicate by check mark whether the registrant is 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. (Check one):

Large accelerated filer	¨	Accelerated Filer	x
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨

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

The aggregate market value of common stock held by non-affiliates of the registrant (28,260,178 shares) as of June 30, 2011, was $637,549,616, based on the closing sales price per share as reported by the New York Stock Exchange on such date.

The number of shares outstanding of the registrant s common stock on February 23, 2012 was 32,725,971 .

DOCUMENTS INCORPORATED BY REFERENCE

Portions from the registrant s Proxy Statement relating to the 2012 Annual Meeting of Stockholders have been incorporated by reference into Part III, Items 10, 11, 12, 13 and 14.

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MERITAGE HOMES CORPORATION

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PART I

Item 1. Business

The Company

Meritage Homes is a leading designer and builder of single-family attached and detached homes based on the number of home closings. We build in the historically high-growth regions of the western and southern United States and offer a variety of homes that are designed to appeal to a wide range of homebuyers, including first-time, move-up, active adult and luxury. We have operations in three regions: West, Central and East, which are comprised of seven states: Arizona, California, Nevada, Texas, Colorado, Florida, and North Carolina. These three regions are our principal business segments. In 2011, we announced our expansion into Raleigh, North Carolina and within Florida into the Tampa market as well as the wind-down of our operations in Nevada. Please refer to Note 11 of the consolidated financial statements for information regarding our operating and reporting segments.

Our homebuilding and marketing activities are conducted primarily under the Meritage Homes brand, except for Arizona and Texas where we also operate under the name Monterey Homes. At December 31, 2011, we were actively selling homes in 157 communities, with base prices ranging from approximately $103,000 to $673,000.

Available Information; Corporate Governance

Meritage Homes Corporation was incorporated in 1988 as a real estate investment trust in the State of Maryland. On December 31, 1996, through a merger, we acquired the homebuilding operations of our predecessor company. We currently focus exclusively on homebuilding and related activities and no longer operate as a real estate investment trust.

Information about our company and communities is provided on our Internet website at *www.meritagehomes.com*. The information contained on our website is not considered part of this Annual Report on Form 10-K. Our periodic and current reports, including any amendments, filed or furnished pursuant to section 13(a) or 15(d) of the Securities Exchange Act of 1934 (the Exchange Act) are available, free of charge, on our website as soon as reasonably practicable after they are electronically filed with or furnished to the Securities and Exchange Commission (SEC).

Meritage operates within a comprehensive plan of corporate governance for the purpose of defining responsibilities and setting high standards for ethical conduct. Our Board of Directors has established an audit committee, executive compensation committee and nominating/governance committee. The charters for each of these committees are available on our website, along with our Code of Ethics and our Corporate Governance Principles and Practices. Our committee charters, Code of Ethics and Corporate Governance Principles and Practices are also available in print, free of charge, to any stockholder who requests any of them by calling us or by writing to us at our principal executive offices at the following address: Meritage Homes Corporation, 17851 North 85th Street, Suite 300, Scottsdale, Arizona 85255, Attention: General Counsel. Our telephone number is (480) 515-8100.

Strategy

All facets of Meritage Homes operations are governed by the principles of our strategic model, Meritage Forward. Meritage Forward defines our culture and operational parameters, ensuring that our actions are aligned around the achievement of our goals. It combines our entrepreneurial spirit, cutting-edge innovation and organizational agility to strive for industry-leading results in all of our functional areas, including: management, land acquisition and development, finance, marketing, sales, purchasing, construction and customer care. The main tenets of Meritage Forward are to:

- Maximize our state-of-the-art market research tools to make informed decisions about land purchases;
- Utilize our knowledge of customer preferences to align our product offerings with the knowledge of our buyers demands through regular surveys and research;

Customize our sales techniques for today s buyers and educate our sales team about the benefits of our Meritage Green offerings and other features of our homes and on the availability of mortgage products;

Continuously improve our construction process by working with our vendors to find mutual efficiencies in order to construct high-quality homes at the lowest possible cost;

Re-engineer and constantly evaluate our pricing, product and community amenity offerings to better appeal to our buyers, while incorporating our Meritage Green concepts and technologies into routine construction practices;

Shorten sales to close cycle time by refining our processes and streamlining scheduling and production;

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Provide the highest level of customer service and care by working closely with our buyers throughout the sales and construction process and monitoring their satisfaction routinely after delivery of their homes; and

Ensure that we have the best team available by hiring and nurturing top talent, expecting top level performance and allocating proper resources to drive execution of our business plan.

All of these directives are focused on our key priority of returning to and sustaining our profitability as the economy stabilizes and recovers.

In connection with our Meritage Forward strategy, we have continued to focus on several initiatives implemented over the last several years. Our Simply Smart Series is a collection of homes that are specifically designed to appeal to the renter and first-time buyer demographic and are marketed on the basis of low monthly payments, which compare favorably to rent payments. We believe these homes compete favorably in our submarkets where low prices are the key determinant of sales activity. The Simply Smart Series offers a base level of standard features while allowing buyers to customize their purchase with a reasonable range of options and upgrades. While we believe these entry level buyers are an important demographic, in recent quarters, we have begun to shift our business back to the move-up market, which has historically comprised our core customer base and is beginning to recover.

To address the influx of available existing home inventory, we offer our *Your Home. Your Way. 99 Days Guaranteed* promise in many of our communities. This program provides our buyers with all the benefits of new home construction, including customization and a warranty, and delivery in 99 days or less from the date the buyer signs the sales contract to the close of their new home. This allows us to effectively compete with the typical closing cycle for resale and foreclosure homes. The expedited timeline works in concert with our streamlined processes driven by Meritage Forward, while maintaining Meritage quality standards.

We continue to innovate building techniques and technologies within Meritage Green, our energy-efficiency program, where every new home we construct, at a minimum, meets 2011 ENERGY STAR® standards. Our commitment to incorporate these energy standards into all of our homes has resulted in our achievement of design, purchasing and production efficiencies that have allowed us to offer these standard features to our home buyers for nominal additional cost. Since mid 2010, we have also opened several extreme green communities that have homes with standard solar features that can save up to 80% on a homeowner s utility bills. Through our green strategy, we continue to lead the industry by incorporating advanced building technologies to build better homes that effectively differentiates our product in the marketplace when compared against both new and resale homes, providing us with a competitive advantage as well as allowing us to be a responsible steward of the environment. Through our green program, the building practices we utilize result in our homeowners utility usage on average being less than half of the current national average of US households. We were the first production builder to offer net-zero homes, where the homes produce as much energy as they use annually. Our ongoing commitment to green is widely recognized, and in 2011, we were again commended for our leadership in advanced green building, including the 2011 *Energy Value Housing Award* from the National Association of Homebuilders for our Lyon s Gate community located in Gilbert, Arizona, the 2011 *ENERGY STAR® Builder Partner of the Year Award*, the 2011 *Best Green Building Program Award*, and the 2011 *People s Choice Award*, recognizing Meritage for voluntarily incorporating energy efficiency in the design, construction and marketing of our homes.

We believe our Meritage Forward strategy and our Meritage Green commitment provides us with unique competitive advantages and will drive our success in attaining our key objectives of maintaining and growing our profitability.

Markets and Products

We currently build and sell homes in the following markets:

Markets	**September 30, Year Entered**
Phoenix, AZ	1985
Dallas/Ft. Worth, TX	1987
Austin, TX	1994
Tucson, AZ	1995
Houston, TX	1997
East Bay/Central Valley, CA	1998
Sacramento, CA	1998
Las Vegas, NV	2002

San Antonio, TX	2003
Inland Empire, CA	2004
Denver, CO	2004
Orlando, FL	2004
Raleigh, NC	2011

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Our homes range from entry level to luxury. A summary of activity by region as of and for the years ended December 31, 2011 and 2010 follows (dollars in thousands):

	September 30, Year Ended December 31, 2011	September 30,	September 30,	September 30, At December 31, 2011	September 30,	September 30,
	# of Homes Closed	Average Closing Price	# Homes in Backlog	$ Value of Backlog	# Home Sites Controlled (1)	# of Actively Selling Communities
West Region						
California	355	$ 338.9	82	$ 27,648	1,527	20
Nevada	59	$ 213.4	5	1,076	425	2
West Region Total	414	$ 321.0	87	28,724	1,952	22
Central Region						
Arizona	594	$ 253.0	158	45,232	6,790	37
Texas	1,660	$ 238.1	396	93,494	5,825	67
Colorado	258	$ 322.1	70	23,493	607	10
Central Region Total	2,512	$ 250.3	624	162,219	13,222	114
East Region						
North Carolina	N/A	$ N/A	24	8,616	241	3
Florida	342	$ 290.5	180	49,295	1,307	18
East Region Total	342	$ 290.5	204	57,911	1,548	21
Total Company	3,268	$ 263.4	915	$ 248,854	16,722	157

	September 30, Year Ended December 31, 2010	September 30,	September 30,	September 30, At December 31, 2010	September 30,	September 30,
	# of Homes Closed	Average Closing Price	# Homes in Backlog	$ Value of Backlog	# Home Sites Controlled (1)	# of Actively Selling Communities
West Region						
California	417	$ 353.0	45	$ 15,295	1,696	14
Nevada	81	$ 197.6	12	2,369	488	4
West Region Total	498	$ 327.7	57	17,664	2,184	18
Central Region						
Arizona	700	$ 223.0	125	31,980	6,686	32
Texas	2,028	$ 240.5	463	111,607	4,759	82
Colorado	162	$ 301.4	52	16,964	596	9

Central Region Total	2,890	$	239.7	640		160,551	12,041	123
East Region								
Florida	312	$	270.7	81		23,601	999	10
Total Company	3,700	$	254.2	778	$	201,816	15,224	151

(1) Home Sites Controlled is the estimated number of homes that could be built on unstarted lots we control, including lots available for sale and on land expected to be developed into lots.

The 9.8% overall increase in our homesites controlled as of December 31, 2011 as compared to the prior year reflects our efforts to execute on our strategy to reposition and re-grow our business in key markets such as California, Texas and Florida. During the last several years, we have exited under-performing markets, sold excess owned lots, terminated lot contracts in less successful subdivisions, purchased and contracted for new projects with smaller lot positions and recalibrated our holdings to be more in line with our current operation volumes.

The average closing price increase in 2011 versus 2010 highlights our successful efforts to acquire, build and sell lots in more desirable locations where we believe there are fewer foreclosures, stronger demand, more marketplace stability, and where we can achieve a higher sales price and stronger margins. The increase also represents a shift in closings volume to the states with higher average sales prices. We believe our land positioning strategies are helping to pave the way for achieving sustainable growth and profitability once more widespread improvements are realized in the economy as a whole and the real estate market.

Recent Industry and Company Developments

In 2011, the national economy as a whole and the homebuilding market in particular did not progress and improve as much as initially anticipated. The prolonged economic downturn led to continued intense competition for homebuyers due to the continued high levels of re-sale and foreclosure homes available. In addition, mortgage financing products remain limited, underwriting standards remain restrictive and buyer confidence has not yet rebounded to its pre-recession levels. Therefore, even though home affordability has significantly improved over the past several years, benefiting from both low prices and low interest rates, market improvement has been slow to regain strength, although we believe we are beginning to see signs of stabilization and improvement in some of our markets. We believe we are well-positioned to capitalize on an improving market, but we remain cautious as we believe any recovery will be uneven across our markets.

We continued to focus on our goals of returning to profitability, while maintaining ample liquidity and a strong balance sheet during 2011. We carefully managed our liquidity, ending the year with cash, cash equivalents, restricted cash and investments and securities balances of $333.2 million. We also benefitted from improving comparatives in many of our key metrics as the year progressed including sales, closings and backlog and community count. We continue to rebuild our lot positions with well-located lots to supplement and replace our older communities as they close out and are actively evaluating opportunities for expansion into new markets. In the first half of 2011, we entered the promising Raleigh-Durham, North Carolina market and commenced sales and construction operations there in the latter half of the year. Additionally, in December 2011 we announced our entry into the Tampa market, expanding our presence in Florida, where we have experienced a high level of success in sales and margins over the last several years. We also announced our decision to wind down operations in the struggling Las Vegas market in December 2011, but we will continue to build and sell through the two remaining actively-selling communities we own there. We believe our strategy provides us with the flexibility necessary given the current market conditions to take advantage of unique opportunities to continue to purchase well-positioned lots in select markets that have been less impacted by the homebuilding downturn over the past several years and we continue to evaluate opportunities in the Southeastern United States.

During this downturn and in line with our Meritage Forward strategy, we have conducted an in-depth market review of each one of our submarkets and have repositioned and redesigned much of our product to increase affordability. Our lower cost structure has enabled us to offer homes at selling prices that compete successfully with re-sales and many foreclosures. In some locations, we designed more efficient floor plans, reduced or eliminated certain standard features from our base home models to re-align them with current market demands and reduced the number of floor plans offered, while continuing to provide an ample selection of options and upgrades, allowing our customers to personalize their new homes with the features they consider most important. In other communities, we are able to capitalize on our construction efficiencies and offer a larger product at a competitive price point, increasing the breadth of our buyer demographics. Our divisions have been working with their subcontractors and vendors to achieve additional price concessions through both materials and labor bid renegotiations, and also through reviews of our entire construction cycle, including even-flow scheduling and process improvement initiatives.

Our active community count increased at year-end to 157 versus 151 a year ago. Although our average sales per community during 2011 was 22.1, relatively consistent with prior year of 22.3, our average sales price increased by $14,000 or 5.5%, year over year. Our unsold inventory consisted of 564 homes as of December 31, 2011, slightly higher than prior year of 519 unsold homes, approximately half of which were complete in both 2011 and 2010. At December 31, 2011, we averaged 3.6 unsold homes per active community.

Land Acquisition and Development

Our current goal is to maintain an approximate four-to-five year supply of lots, which we believe provides an appropriate planning horizon to address regulatory matters and land development. To better leverage our existing overhead, we are currently focused on expanding our market share in our key markets and their adjacent submarkets and continue to explore exceptional opportunities outside of our existing markets. As of December 31, 2011 we have a 5.1-year supply of lots, based on 2011 closings, although 13.9% of our holdings are in master-planned Active Adult communities that traditionally contain a significantly larger supply of lots and, accordingly, have a longer lot position. We continually evaluate our markets, monitoring our lot supplies to ensure we have a sufficient pipeline, and are committed to growing our active community count in key locations.

Today, we are purchasing a combination of finished lots and partially-developed or un-developed lots. Finished lots are those on which the development has already been completed and they are ready for immediate home construction. When evaluating land acquisitions, our selection is based upon a variety of factors, including:

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- surrounding demographics based on extensive marketing studies, including surveys of both new and resale homebuyers;
- existing concentration of contracted lots in surrounding markets, including nearby Meritage communities;
- suitability for development, generally within a three to five-year time period from the beginning of the development process to the delivery of the last home;
- financial feasibility of the proposed project, including projected profit margins, returns on capital invested, and the capital payback period;
- the ability to secure governmental approvals and entitlements, if required;
- results of environmental and legal due diligence;
- proximity to local traffic corridors and amenities;
- availability of seller-provided purchase options that allow us to defer lot purchases until needed for production; and
- management s judgment as to the real estate market and economic trends, and our experience in particular markets.

When purchasing undeveloped or partially developed land, we generally acquire land only after necessary entitlements have been obtained so that development or construction may begin as market conditions dictate. The term entitlements refers to development agreements and tentative maps or recorded plats, depending on the jurisdiction within which the land is located. Entitlements generally give the developer the right to obtain building permits upon compliance with conditions that are ordinarily within the developer s control. Even though entitlements are usually obtained before land is purchased, we are typically still required to secure a variety of other governmental approvals and permits prior to and during development. The process of obtaining such approvals and permits can substantially delay the development process. We may consider, on a limited basis, the purchase of unentitled property when we can do so in a manner consistent with our business strategy. Historically, we have developed parcels ranging from 100 to 300 lots, although over the past several years we have been primarily focused on limited lot purchases of smaller groups of lots. In order to achieve and maintain an adequate lot inventory, we have also historically purchased larger parcels, in some cases with joint venture partners. In some cases, these joint ventures purchase undeveloped land and develop the land themselves. In select cases, we may also acquire distressed assets from banks, governmental entities, or opportunity funds.

Once we secure undeveloped land, we generally initiate development through contractual agreements with subcontractors. These activities include site planning and engineering, as well as constructing road, sewer, water, utilities, drainage, recreation facilities and other improvements and refinements. We frequently build homes in master-planned communities with home sites that are along or near major amenities, such as golf courses or recreation facilities.

The factors used to evaluate finished lot purchases are similar to those for land we intend to develop ourselves, although the development risks associated with the undeveloped land financial, environmental, legal and governmental have been borne by others. Therefore, these finished lots are more attractive to us, despite their higher price, as we can immediately begin home construction.

We develop a design and marketing concept tailored to each community, which includes the determination of size, style and price range of homes. We may also determine street layout, individual lot size and layout, and overall community design for these projects. The product lines offered depend upon many factors, including the guidelines, if any, of an existing community, housing generally available in the area, the needs and desired housing product for a particular market, and our lot sizes, though we are increasingly able to use standardized design plans across our communities.

We typically acquire land through land purchase and option contracts. Purchases are generally financed through our working capital or corporate borrowings. Acquiring our land through option contracts, when available, allows us to control the timing and volume of lot and land purchases from the third parties and minimizes our up-front cash outlay. We typically enter into option contracts to purchase finished lots at pre-determined prices during a specified period of time from these third parties, usually structured to approximate our projected absorption rate at the time the contract is negotiated. These contracts are generally non-recourse and typically require the payment of non-refundable deposits of 5% to 15% of the sales

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price. We believe the use of options limits the market risks associated with land ownership by allowing us to re-negotiate option terms or terminate options in the event of declines in land value and/or market downturns. The recent availability of such option lots has been drastically reduced. If market conditions deteriorate, we might attempt to re-negotiate our option and purchase contracts to achieve terms more consistent with market conditions. Such adjustments could include deferment, or reduction in lot takedown requirements and price concessions. If we are not successful in these re-negotiations, we might determine that a project is no longer feasible or desirable and cancel these contracts, usually resulting in the forfeiture of our option deposits and any associated capitalized pre-acquisition costs.

As of December 31, 2011, we believe that nearly all of our option contracts that were initially entered into before the housing downturn and that had terms that currently could make them economically not viable have been either renegotiated or terminated.

During 2011, in light of difficult market conditions, we forfeited some of our rights to acquire land via option or other similar contracts, terminating options on about 338 lots, and we wrote off option deposits and pre-acquisition costs of $2.8 million during the year. At December 31, 2011, in addition to our approximately 13,887 owned lots, we also had approximately 2,835 committed lots under option or contract for a total purchase price of approximately $157.8 million, with $14.9 million in cash deposits. Additional information relating to our impairments is discussed in Note 2 Real Estate and Capitalized Interest, and information related to lots and land under option is presented in Note 3 Variable Interest Entities and Consolidated Real Estate Not Owned in the accompanying consolidated financial statements.

All lot acquisitions are reviewed by our corporate land acquisition committee, which is comprised of our senior management team and key operating and financial executives. All land acquisitions exceeding pre-specified limits must also be approved by our Board of Directors.

The following table presents information as of December 31, 2011 (dollars in thousands):

	September 30,	September 30,	September 30,	September 30,
	Number of Lots Owned (1)		Number of Lots	Total Number
	Finished	Under Development and Held for Sale	Under Contract or Option (1)(2)	of Lots Controlled
West Region				
California	1,094	370	63	1,527
Nevada	425	0	0	425
West Region Total	1,519	370	63	1,952
Central Region				
Arizona	2,570	3,831	389	6,790
Texas	1,636	2,648	1,541	5,825
Colorado	227	89	291	607
Central Region Total	4,433	6,568	2,221	13,222
East Region				
North Carolina	79	109	53	241
Florida	525	284	498	1,307
East Region Total	604	393	551	1,548
Total Company	6,556	7,331	2,835	16,722
Total book cost (3)	$ 347,139	$ 219,703	$ 14,867	$ 581,709

(1) Excludes lots with finished homes or homes under construction. The number of lots is an estimate and is subject to change.

(2) There can be no assurance that we will actually acquire any lots under option or purchase contract. These amounts do not include approximately 680 lots under contract with $341,000 of refundable earnest money deposits, for which we have not completed due diligence and, accordingly, have no money at risk and are under no obligation to perform under the contract.

(3) For Lots Owned, book cost primarily represents land, development and capitalized interest. For Lots under Contract or Option, book cost primarily represents earnest and option deposits.

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Investments in Unconsolidated Entities   Joint Ventures

Historically, we have participated in land development joint ventures as a means of accessing larger parcels of land and lot positions, expanding our market opportunities, managing our risk profile and leveraging our capital base; however, in recent years, such ventures have not been a significant avenue for us to access lots. We currently have only two such active ventures. We also participate in six mortgage and title business joint ventures. The mortgage joint ventures are engaged in, or invest in mortgage companies that engage in, mortgage brokerage activities, and they originate and provide services to both our customers and other homebuyers.

In connection with our land development joint ventures, we may also provide certain types of guarantees to associated lenders and municipalities.

Construction Operations

We act as the general contractor for our projects and typically hire experienced subcontractors on a geographic basis to complete construction at a fixed price. We usually enter into agreements with subcontractors and materials suppliers on an individual basis after receiving competitive bids. We obtain information from prospective subcontractors and suppliers with respect to their financial condition and ability to perform their agreements before formal bidding begins. We also enter into longer-term contracts with subcontractors and suppliers, where possible, to obtain more favorable terms, minimizing construction costs. Our contracts require that our subcontractors comply with all laws pertaining to their work, follow local building codes and permits, and meet performance standards. Following our Meritage Forward strategy, purchasing and construction managers coordinate and supervise the activities of subcontractors and suppliers, and monitor compliance with zoning and building codes. At December 31, 2011, we employed approximately 164 full-time construction operations personnel.

We specify that quality durable materials be used in construction of our homes and we do not maintain significant inventories of construction materials, except for work in process materials for homes under construction. When possible, we negotiate price and volume discounts and rebates with manufacturers and suppliers on behalf of our subcontractors so we can take advantage of production volume. Our raw materials consist primarily of lumber, concrete and similar construction materials and are generally purchased on a national or regional level. Such materials have historically been available from multiple suppliers and therefore we do not believe there is a supplier risk concentration. Because such materials are comprised substantially of natural resource commodities, however, their cost and availability is subject to national and worldwide price fluctuations and inflation, each of which could be impacted by legislation relating to energy and climate change.

We generally build and sell homes in phases within our larger projects, which we believe creates efficiencies in land development and home construction operations and cash management, and improves customer satisfaction by reducing the number of vacant lots and construction activity surrounding a completed home. Our homes are typically completed within two to four months from the start of construction, depending upon the geographic location and the size and complexity of the home; although, as previously discussed, we have a 99-day guarantee at select communities where the entire home purchase cycle from the time a buyer signs a contract to close is just 99 days or less. Construction schedules may vary depending on the size of the home, availability of labor, materials and supplies, product type, location and weather. Our homes are usually designed to promote efficient use of space and materials, and to minimize construction costs and time. We typically do not enter into any derivative contracts to hedge against weather or materials fluctuations as we do not believe they are particularly advantageous to our operations, although we do lock in long-term pricing with our vendors for certain key construction commodities.

Marketing and Sales

We believe that we have an established reputation for building high quality homes, which helps generate demand in each new project. We also use advertising and other promotional activities, including our website at *www.meritagehomes.com*, social media outlets, magazine and newspaper advertisements, brochures, direct mailings and the placement of strategically located signs in the vicinities around our developments. Our marketing strategy is aimed at differentiating us from other new homebuilders, traditional resale homes and, more recently, foreclosure and short sale homes.

We use furnished model homes as a marketing tool to demonstrate to prospective homebuyers the advantages of the designs and features of our homes. We generally employ or contract with interior and landscape designers who create attractive model homes and complexes that highlight the options available for the product line within a project. We generally build between one and three model homes for each actively selling community, depending upon the number of homes to be built in the project and the products to be offered. In our Meritage Green communities, we have built over 50 learning centers , where we have partially de-constructed models in order to provide our buyers with the ability to see first-hand what green features are included in their home and the impact these features have on their utility bills. In conjunction with the learning centers, our sales and marketing efforts use testimonials from actual homebuyers in order to showcase real-life examples of how green features impact the bottom line of our buyers utility bills.

We sell and lease back some of our model homes from individual buyers who do not intend to occupy the home immediately. At December 31, 2011, we owned 191 and leased 19 model homes and had an additional 12 models under construction.

Our homes generally are sold by our commissioned employees who typically work primarily from a sales office located in one of the model homes for each project. We also employ a team of online sales associates who offer assistance to potential buyers viewing our products over the Internet. At December 31, 2011, we had approximately 281 full-time sales and marketing personnel. Our goal is to ensure that our sales force has extensive knowledge of our housing product, our green features, our sales strategies, and community dynamics, in order to fully execute our marketing message. To achieve this goal, we train our sales associates and conduct regular meetings to update them on our product, sales techniques, competitive products in the area, financing availability and credit score repair opportunities, construction schedules, marketing and advertising plans and the available product lines, pricing, options and warranties offered, as well as the numerous benefits and savings our green product offers. Our sales associates are licensed real estate agents where required by law. Independent brokers may also sell our homes, and are usually paid a sales commission based on the price of the home. Our sales associates assist our customers in adding available customization features to their homes, which we design to appeal to local consumer demands. We mainly contract with third-party design studios that specialize in assisting our homebuyers with options and upgrades to personalize their homes. Utilizing these third-party design studios allows us to manage our overhead and costs more efficiently. We may also offer various sales incentives, including price concessions, assistance with closing costs, and landscaping or interior upgrades, to attract buyers. The use and type of incentives depends largely on economic and local competitive market conditions.

We have taken significant strides in further setting ourselves apart from our competitors through our Meritage Green strategy and product line-up. We believe our ongoing commitment to design and build energy-efficient homes taps into a buyer s sensitivities of how eco-friendly designs help impact both the environment, as well as their pocketbook. We further believe it is strategies such as this that have helped us weather the prolonged downward pressure on buyer demand and to maintain our status as one of the leading homebuilders.

Backlog

We generally require a signed sales contract to release a lot to start construction, although on a regular basis we also start a certain number of homes for speculative sales inventory, as we have had a high level of success with these quick move-in opportunities. Our sales contracts require cash deposits and are usually subject to certain contingencies such as the buyer s ability to qualify for financing. Additional deposits are usually collected upon the selection of options and upgrades. Homes covered by such sales contracts but which are not yet closed are considered backlog and are representative of potential future revenues. Started homes are excluded from backlog until a sales contract is signed and are referred to as unsold or spec inventory. Sales contingent upon the sale of a customer s existing home are not considered a sale until the contingency is removed. We start homes without sales contracts in order to increase inventory levels to meet demand for quick move-ins for the renter and first-time buyer demographic and, at times, to close out a community.

We do not recognize any revenue from home sales until a finished home is delivered to the homebuyer, payment is collected and other criteria for sale and profit recognition are met. At December 31, 2011, of our total homes in inventory, 18.2% were under construction without sales contracts and 27.4% were completed homes without sales contracts. A substantial majority of the unsold homes resulted from homesites that began construction with a valid sales contract that was subsequently cancelled. We believe that during 2012 we will deliver to customers substantially all homes in backlog at December 31, 2011 under existing or, in the case of cancellations, replacement sales contracts.

Our backlog increased 17.6% to 915 units with a value of approximately $248.9 million at December 31, 2011 from 778 units with a value of approximately $201.8 million at December 31, 2010. These increases are due to our higher sales and the increase in community count in the fourth quarter of 2011 as compared to the same period a year ago.

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Customer Financing

We attempt to help qualified homebuyers who require financing to obtain loans from mortgage lenders that offer a variety of financing options. While our homebuyers may obtain financing from any provider of their choice, we have entered into several joint venture arrangements with established mortgage brokers in most of our markets that allow those ventures to primarily act as a preferred mortgage broker to our buyers to help facilitate the sale and closing process as well as generate additional fee income. In some markets we also use unaffiliated preferred mortgage lenders. We may pay a portion of the closing costs to assist homebuyers with financing. Since many customers use long-term mortgage financing to purchase homes, the current decrease of availability of mortgage loans, tighter underwriting standards and the collapse of the sub-prime loan market have reduced the availability of such loans to our homebuyers, although recent decreases in interest rates have increased the affordability of mortgage payments for some of our potential buyers.

Customer Relations, Quality Control and Warranty Programs

We believe that positive customer relations and an adherence to stringent quality control standards are fundamental to our continued success, and that our commitment to buyer satisfaction and quality control has significantly contributed to our reputation as a high-quality builder.

In accordance with our company-wide standards, a Meritage project manager or superintendent and a customer relations representative generally monitor compliance with quality control standards for each community. These representatives perform the following tasks:

- oversee home construction;
- monitor subcontractor and supplier performance;
- manage the scheduling and construction completion deadlines;
- conduct formal inspections as specific stages of construction are completed; and
- regularly update buyers on the progress of their homes and coordinate the closing process.

We generally provide a one-to-two-year limited warranty on workmanship and building materials and a ten-year warranty for structural defects on each home we build. We generally require our subcontractors to provide an indemnity and a certificate of insurance before beginning work, and therefore any claims relating to workmanship and materials are generally the subcontractors responsibility. With the assistance of an actuary, we have estimated and established reserves for future structural warranty costs based on the number of home closings and historical data trends for our communities. Warranty reserves generally range from 0.2% to 0.7% of a home s sale price. Those projections are subject to variability due to uncertainties regarding structural defect claims for the products we build, the markets in which we build, claim settlement history, insurance and legal interpretations, among other factors. Historically, these reserves have been sufficient to cover out-of-pocket costs that we were required to absorb for warranty repairs.

Competition and Market Factors

The development and sale of residential property is a highly-competitive industry. We compete for sales in each of our markets with national, regional and local developers and homebuilders, although recently our primary competition has been existing home resales, foreclosures, and to a lesser extent, condominiums and rental housing. Some of our competitors have significantly greater financial resources and may have lower costs than we do. Competition among both small and large residential homebuilders is based on a number of interrelated factors, including location, reputation, amenities, design, quality and price. We believe that we compare favorably to other homebuilders in the markets in which we operate due to our:

experience within our geographic markets which allows us to develop and offer products that are in line with the needs and desires of the targeted demographic;

streamlined construction processes that allow us to save on material, labor and time and pass those savings to our customers in the form of lower prices;

ENERGY STAR® standards in all of our communities and incremental green features that create additional benefits to our customers and differentiate our product from competing new and existing homes inventory;

ability to recognize and adapt to changing market conditions, from both a capital and human resource perspective;

ability to capitalize on opportunities to acquire land on favorable terms; and

reputation for outstanding service and quality products.

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Although the current economic uncertainty has impacted our sales efforts, our new product offerings and strategic locations are successfully competing with both existing homes inventory and surrounding new-home communities as evidenced by our year-over-year gains in sales and backlog, and we expect that once the market stabilizes, the strengths noted above will continue to provide us with long-term competitive advantages.

We have an extensive market research department, whose goal is to assist our divisions in each of our local markets to better compete with other homebuilders, and the inventory of foreclosure and re-sale homes in surrounding neighborhoods. Our strategic operations team conducts in-depth community-level reviews in each of our markets, including a detailed analysis of existing inventory, pricing, buyer demographics and the identification of each location s key buyer metrics. This analysis and resulting analytical tools assist in decision-making regarding product designs, positioning, and pricing and underwriting standards for lot purchases and land development. Additionally, our market research department is also focused on evaluating and identifying new market opportunities. The anlaysis of entry into a new market includes comprehensive research and surveys of buyer demographics and demands, competitor composition and performance, the surrounding job market and employment statistics, foreclosure activity and desirability of the market in general. Based on the results of our market research, we successfully entered the Raleigh-Durham market in 2011 and announced our entry into the Tampa market.

Government Regulation and Environmental Matters

To the extent that we acquire undeveloped land, it is primarily acquired after entitlements have been obtained. Construction may begin almost immediately on such entitled land upon compliance with and receipt of specified permits, approvals and other conditions, which generally are within our control. The time needed to obtain such approvals and permits affects the carrying costs of unimproved property acquired for development and construction. The continued effectiveness of permits already granted is subject to factors such as changes in government policies, rules and regulations, and their interpretation and application. To date, the government approval processes discussed above have not had a material adverse effect on our development activities, although there is no assurance that these and other restrictions will not adversely affect future operations as, among other things, sunset clauses may exist on some of our entitlements and could lapse.

Local and state governments have broad discretion regarding the imposition of development fees for projects under their jurisdictions. These fees are normally established when we receive recorded maps or plats and building permits. Communities may also require concessions or may require the builder to construct certain improvements to public places such as parks and streets. In addition, communities may impose construction moratoriums. Because most of our land is entitled, construction moratoriums generally would not affect us in the near term unless they arise from health, safety or welfare issues, such as insufficient water, electric or sewage facilities. In the long term, we could become subject to delays or may be precluded entirely from developing communities due to building moratoriums, no growth or slow growth initiatives or building permit allocation ordinances, which could be implemented in the future.

In addition, there is a variety of new legislation being enacted, or considered for enactment at the federal, state and local level relating to energy and climate change. This legislation relates to items such as carbon dioxide emissions control and building codes that impose energy efficiency standards. New building code requirements that impose stricter energy efficiency standards could significantly increase our cost to construct homes, although our green initiatives meet, and in many instances exceed, current and expected energy efficiency thresholds. As climate change concerns continue to grow, legislation and regulations of this nature are expected to continue and may result in increased costs. Similarly, energy-related initiatives affect a wide variety of companies throughout the United States and the world, and because our operations are heavily dependent on significant amounts of raw materials, such as lumber, steel, and concrete, they could have an indirect adverse impact on our operations and profitability to the extent the manufacturers and suppliers of our materials are burdened with expensive carbon dioxide emissions control and energy related regulations.

We are also subject to a variety of local, state, and federal statutes, ordinances, rules and regulations concerning the protection of health and the environment. In some markets, we are subject to environmentally sensitive land ordinances that mandate open space areas with public elements in housing developments, and prevent development on hillsides, wetlands and other protected areas. We must also comply with flood plain restrictions, desert wash area restrictions, native plant regulations, endangered species acts and view restrictions. These and similar laws may result in delays, cause substantial compliance and other costs, and prohibit or severely restrict development in certain environmentally sensitive regions or areas. To date, compliance with such ordinances has not materially affected our operations, although it may do so in the future.

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We usually will condition our obligation to acquire property on, among other things, an environmental review of the land. To date, we have not incurred any unanticipated liabilities relating to the removal of unknown toxic wastes or other environmental matters. However, there is no assurance that we will not incur material liabilities in the future relating to toxic waste removal or other environmental matters affecting land currently or previously owned.

In order for our homebuyers to finance their home purchases with FHA-insured or VA-guaranteed or USDA-guaranteed mortgages, we are required to build such homes in accordance with the regulatory requirements of those agencies.

Some states have statutory disclosure requirements governing the marketing and sale of new homes. These requirements vary widely from state to state.

Some states require us to be registered as a licensed contractor, a licensed real estate broker and in some markets our sales agents are required to be registered as licensed real estate agents.

Employees, Subcontractors and Consultants

At December 31, 2011, we had approximately 660 full-time employees, including approximately 215 in management and administration, 281 in sales and marketing, and 164 in construction operations. Our operations are carried out through both local and centralized corporate management. Local operations are made up of our division employees, led by management with significant homebuilding experience and who typically possess a depth of knowledge in their particular markets. Our centralized corporate management sets our strategy and leads decisions related to our overall strategies related to land acquisition, risk management, finance, cash management and information systems. Our employees are not unionized, and we believe that we have good employee relationships. We pay for a substantial portion of our employees insurance costs, with the balance contributed by the employees. We also have a 401(k) savings plan, which is available to all employees who meet the plan s participation requirements. All of our employees, including officers and directors, are required to comply with our Code of Ethics and to immediately report through the appropriate channels, any known instances of non-compliance.

We act solely as a general contractor, and all construction operations are supervised by our project managers and field superintendents who manage third party subcontractors. We use independent consultants and contractors for architectural, engineering, advertising and some legal services, and we strive to maintain good relationships with our subcontractors and independent consultants and contractors.

Seasonality

Historically, we experienced seasonal variations in our quarterly operating results and capital requirements. We typically sell more homes in the first half of the fiscal year than in the second half, which creates additional working capital requirements in the second and third quarters to build our inventories to satisfy the deliveries in the second half of the year. We typically benefit from the cash generated from home closings in the third and fourth quarters. We expect this seasonal pattern to continue over the long term, although it has been and may continue to be affected by the current volatility in the homebuilding industry.

Item 1A. Risk Factors

The risk factors discussed below are factors that we believe could significantly impact our business, if they occur. These factors could cause results to differ materially from our historical results or our future expectations.

Risk Factors Related to our Business

If the current downturn becomes more severe or continues for an extended period of time, it would have continued negative consequences on our operations, financial position and cash flows.

Continued weakness in the homebuilding industry could have an adverse effect on us. It could require that we write off or write down more assets, dispose of assets, reduce operations, restructure our debt and/or raise new equity or debt to pursue our business plan, any of which could have a detrimental effect on our current stakeholders.

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Although in 2011 we recorded a net loss, we were able to maintain cash reserves and keep our net-debt to capital ratio within our internal target threshold. In the last five years we recorded sizable real-estate impairments that eroded our equity from our historical pre-downturn levels. Additional external factors, such as the duration of the economic downturn and high foreclosure and employment rates could put additional downward pressure on our results. Although we are seeing some signs of stabilization and potential recovery in certain markets, it is uncertain how much longer the current economic uncertainty will continue and what the negative effect may be to our financial results.

Mortgage availability decreases and interest rate increases may make purchasing a home more difficult and may cause an increase in the number of new and existing homes available for sale.

In general, housing demand is adversely affected by the lack of availability of mortgage financing and increases in interest rates. Continued high levels of foreclosures and sales of existing inventories of previously foreclosed homes could increase the available home inventory supply, which may result in price reductions. Most of our buyers finance their home purchases through our mortgage joint ventures or third-party lenders providing mortgage financing. If mortgage interest rates increase and, consequently, the ability of prospective buyers to finance home purchases is adversely affected, home sales, gross margins and cash flow may also be adversely affected and the impact may be material. Although long-term interest rates currently remain at historically low levels, it is impossible to predict future increases or decreases in market interest rates.

Homebuilding activities also depend, in part, upon the availability and costs of mortgage financing for buyers of homes owned by potential customers, as those customers (move-up buyers) often must sell their residences before they purchase our homes. Mortgage lenders continue to be subject to more restrictive underwriting standards by the regulatory authorities which oversee them as a consequence of the sub-prime mortgage market failures, among other reasons. Additionally, potential home buyers who have previously foreclosed or short-sold a home may be precluded from obtaining a mortgage for several years. During 2011, there have been enhanced regulatory and legislative actions with respect to consumer mortgage loans which have hindered the comeback of a more stable consumer mortgage lending environment. Such actions include increased Fannie Mae and Freddie Mac lender fees that were mandated by Congress in an effort to offset a temporary reduction in payroll taxes. Additionally, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd Frank Act), was signed into law in 2010, which established several new standards and requirements relating to the origination, securitization and servicing of residential consumer mortgage loans. In addition, the United States and international banking regulators have proposed or enacted higher capital standards and requirements for financial institutions. These standards and requirements, as and when implemented, could further tighten the availability and/or increase the costs to borrowers to obtain such loans. Continued legislative actions and more stringent underwriting standards could have a material adverse effect on our business if certain buyers are unable to obtain mortgage financing. A prolonged tightening of the financial markets could also negatively impact our business.

Expirations, amendments or changes to tax laws, incentives or credits currently available to our homebuyers may negatively impact our business.

Significant changes to existing tax laws that currently benefit our homebuyers, such as the ability to deduct mortgage interest and real property taxes, may result in an increase in the total cost of home ownership and may make the purchase of a home less attractive to our buyers.

If home prices decline, potential buyers may not be able to sell their existing homes, which may negatively impact our sales.

As a participant in the homebuilding industry, we are subject to market forces beyond our control. In general, housing demand is impacted by the affordability of housing. Many homebuyers need to sell their existing homes in order to purchase a new home from us, and continued weakness in the home resale market or further decreases in home sale prices could adversely affect that ability. Declines in home prices would have an adverse effect on our homebuilding business margins and cash flows.

High cancellation rates may negatively impact our business.

Our backlog reflects the number and value of homes for which we have entered into non-contingent sales contracts with customers but have not yet delivered those homes. Although these sales contracts typically require a cash deposit and do not make the sale contingent on the sale of the customer s existing home, a customer may in certain circumstances cancel the contract and receive a complete or partial refund of the deposit as a result of local laws or contract provisions. If home prices decline, the national or local homebuilding environment remains weak or declines further or interest rates increase, homebuyers may have an incentive to cancel their contracts with us, even where they might be entitled to no refund or only a partial refund. Significant cancellations have previously had, and could in the future have, a material adverse effect on our business as a result of lost sales revenue and the accumulation of unsold housing inventory.

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Our future operations may be adversely impacted by high inflation.

We, like other homebuilders, may be adversely affected during periods of high inflation, mainly from higher land and construction and materials costs. Also, higher mortgage interest rates may significantly affect the affordability of mortgage financing to prospective buyers. Inflation could increase our cost of financing, materials and labor and could cause our financial results or growth to decline. Traditionally, we have attempted to pass cost increases on to our customers through higher sales prices. Although inflation has not historically had a material adverse effect on our business, sustained increases in material costs would have a material adverse effect on our business if we are unable to correspondingly increase home sale prices.

A reduction in our sales absorption levels may force us to incur and absorb additional community-level costs.

We incur certain overhead costs associated with our communities, such as marketing expenses and costs associated with the upkeep and maintenance of our model and sales complexes. If our sales absorptions pace decreases and the time required to close out our communities is extended, we would likely incur additional overhead costs, which would negatively impact our financial results. Additionally, we incur various land development improvement costs for a community prior to the commencement of home construction. Such costs include infrastructure, utilities, taxes and other related expenses. Reduction in home absorption rates increases the associated holding costs, our time to recover such costs, and the value of such assets. Further declines in the homebuilding market may also require us to evaluate the recoverability of costs relating to land acquired more recently.

The value of our real estate inventory may further decline, leading to impairments and reduced profitability.

A limited portion of our remaining owned land was purchased at prices that reflected the strong homebuilding and real estate markets experienced during the mid 2000s. As such, we wrote down the value of certain inventory over the last several years to reflect current market conditions and have abandoned certain projects. To the extent that we still own or have options/purchase agreements related to such land parcels, a further decline in the homebuilding market may require us to re-evaluate the value of our land holdings and we could incur additional impairment charges, which would decrease both the book value of our assets and stockholders equity.

Our long-term success depends on the availability of finished lots and undeveloped land that meet our land investment criteria.

The availability of finished and partially developed lots and undeveloped land that meet our investment and marketing standards depends on a number of factors outside of our control, including land availability in general, competition with other homebuilders and land buyers, credit market conditions, legal and government agency processes, inflation in land prices, zoning, our ability and the costs to obtain building permits, the amount of environmental impact fees, property tax rates and other regulatory requirements. Should suitable lots or land become less available, the number of homes that we may be able to build and sell could be reduced, and the cost of attractive land could increase, which could adversely impact our financial results. The availability of suitable land assets could also affect the success of our strategic land acquisition strategy, which may impact our ability to increase the number of actively selling communities, to grow our revenues and margins, and to achieve or maintain profitability.

Reduced levels of sales may cause us to re-evaluate the viability of existing option contracts, resulting in a potential termination of these contracts which may lead to further impairment charges.

Historically, a significant portion of our lots were controlled under option contracts. Such options generally require a cash deposit that will be forfeited if we do not exercise the option. During the last several years, we forfeited significant amounts of deposits and wrote off related pre-acquisition costs related to projects we no longer deemed feasible, as they were not generating acceptable returns. Although our remaining pool of optioned projects has significantly decreased due to abandonments and the unwillingness of sellers to provide option terms, an additional downturn in the homebuilding market may cause us to re-evaluate the feasibility of our remaining optioned projects, which may result in writedowns that would reduce our assets and stockholders equity.

Our business may be negatively impacted by natural disasters.

Our homebuilding operations include operations in Texas, California, North Carolina and Florida. Some of our markets in Texas, North Carolina and Florida occasionally experience extreme weather conditions such as tornadoes and/or hurricanes. California has experienced a significant number of earthquakes, wildfires, flooding, landslides and other natural disasters in recent years. We do not insure against some of these risks. These occurrences could damage or destroy some of our homes under construction or our building lots, which may result in uninsured or underinsured losses. We could also suffer significant construction delays or substantial fluctuations in the pricing or availability of building materials. Any of these events could cause a decrease in our revenue, cash flows and earnings.

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Our joint ventures with independent third parties may be illiquid, and we may be adversely impacted by our joint venture partners failure to fulfill their obligations.

We occasionally participate in land acquisition and development joint ventures with independent third parties, in which we have less than a controlling interest. Our participation in these types of joint ventures has decreased over the last few years due to current market conditions and the reduced need for lots, and we have reduced our involvement in such ventures to just two active land joint ventures. Historically, these joint ventures were structured to provide us with a means of accessing larger parcels and lot positions and to help us expand our marketing opportunities and manage our risk profile. However, these joint ventures often acquire parcels of raw land without entitlements and as such are subject to a number of development risks that our business does not face directly. These risks include the risk that anticipated projects could be delayed or terminated because applicable governmental approvals cannot be obtained, timely obtained or obtained at reasonable costs. In addition, the risk of construction and development cost overruns can be greater for a joint venture where it acquires raw land compared to our typical acquisition of entitled lots. These increased development and entitlement risks could have a material adverse effect on our financial position or results of operations if one or more joint venture projects is delayed, cancelled or terminated or we are required, whether contractually or for business reasons, to invest additional funds in the joint venture to facilitate the success of a particular project.

Our joint venture investments are generally very illiquid both because we often lack a controlling interest in the ventures and because most of our joint ventures are structured to require super-majority or unanimous approval of the members to sell a substantial portion of the joint venture s assets or for a member to receive a return of their invested capital. Our lack of a controlling interest also results in the risk that the joint venture will take actions that we disagree with, or fail to take actions that we desire, including actions regarding the sale or financing of the underlying property. In the ordinary course of our business, we provide letters of credit and performance, maintenance and other bonds in support of our related obligations with respect to the development of our joint venture projects. We had no such letters of credit or bonds as of December 31, 2011. In limited cases, we may also offer pro-rata limited repayment guarantees on our portion of the joint venture debt or other debt repayment guarantees. Our limited repayment guarantees were $0.3 million as of December 31, 2011.

With respect to certain of our joint ventures, we and our joint venture partners may be obligated to complete land development improvements if the joint venture does not perform the required development, which could require significant expenditures. In addition, we and our joint venture partners sometimes agree to indemnify third party surety providers with respect to performance bonds issued on behalf of certain of our joint ventures. In the event the letters of credit or bonds are drawn upon, we, and in the case of a joint venture, our joint venture partners, would be obligated to reimburse the surety or other issuer of the letter of credit or bond if the obligations the bond or guarantee secures are not performed by us (or the joint venture). If one or more bonds, letters of credit or other guarantees were drawn upon or otherwise invoked, we could have additional financial obligations.

As of December 31, 2011, we were involved in legal proceedings over certain guarantees relating to a large joint venture in which we hold less than a 4% interest. We cannot guarantee that additional events will not occur or that such obligations will not be invoked, although at December 31, 2011 we have a very limited number of such guarantees related to our existing joint ventures.

If we are unable to successfully compete in the highly competitive housing industry, our financial results and growth may suffer.

The housing industry is highly competitive. We compete for sales in each of our markets with national, regional and local developers and homebuilders, existing home resales (including foreclosures) and, to a lesser extent, condominiums and available rental housing. Some of our competitors have significantly greater financial resources and some may have lower costs than we do. Competition among both small and large residential homebuilders is based on a number of interrelated factors, including location, reputation, amenities, design, quality and price. Competition is expected to continue and may become more intense, and there may be new entrants in the markets in which we currently operate and in markets we may enter in the future and our industry may also experience some consolidations. If we are unable to successfully compete, our financial results and growth could suffer.

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Some homebuyers may cancel their home purchase contracts with us because their deposits are generally a small percentage of the purchase price and are potentially refundable.

In connection with the purchase of a home, our policy is to generally collect a deposit from our customers, although typically, this deposit reflects a small percentage of the total purchase price, and due to local regulations, the deposit may, in certain circumstances, be fully or partially refundable prior to closing. If the prices for our homes in a given community decline further, our neighboring competitors increase their sales incentives, interest rates increase, the availability of mortgage financing tightens or there is a further downturn in local, regional or national economies, homebuyers may cancel their home purchase contracts with us. In past years, we experienced above-normal cancellation rates, although in 2010 and 2011 cancellation rates returned to historical levels. Continued uncertainty in the homebuilding market could adversely impact our cancellation rates, which would have a negative effect on our results of operations.

We are subject to construction defect and home warranty claims arising in the ordinary course of business, which may lead to additional reserves or expenses.

Construction defect and home warranty claims are common in the homebuilding industry and can be costly. Therefore, in order to account for future potential obligations, we establish a warranty reserve in connection with every home closing. Additionally, we maintain general liability insurance and generally require our subcontractors to provide insurance coverage and indemnify us for liabilities arising from their work; however, we cannot be assured that our warranty reserves and those insurance rights and indemnities will be adequate to cover all construction defect and warranty claims for which we may be held liable. For example, we may be responsible for applicable self-insured retentions, and certain claims may not be covered by insurance or may exceed applicable coverage limits.

During 2009 we recorded a charge of $6.0 million associated with the repair of less than 100 homes built by us in 2005 and 2006 in Florida that we had then confirmed to contain defective drywall manufactured in China. We have more recently determined that of these homes, approximately 95 homes we constructed in Florida and less than 10 homes we constructed in the Houston, Texas area during 2005 and 2006 contain the defective drywall. We have been named as a defendant in several omnibus complaints as part of one Federal Court lawsuit and one Florida State Court lawsuit relating to Chinese drywall. The Florida State case has been resolved and dismissed. It is possible that we may, in the future, be subject to additional litigation relating to defective Chinese drywall. We believe our existing warranty reserves are sufficient to cover costs and claims associated with the repair of the above-mentioned homes. As of December 31, 2011, we completed our repair of most of these homes and have been reimbursed for a significant portion of our costs to date and anticipate that any future costs will also be substantially reimbursed through both our insurance provider as well as the manufacturers, and our subcontractors and suppliers and/or their insurance providers. We do not anticipate significant additional spending related to the homes confirmed to contain the defective drywall. However, if and to the extent the scope of the defective Chinese drywall issue increases beyond our projections, or in the event defective Chinese drywall is, through credible evidence, linked to significant adverse health effects of the occupants of the homes containing such defective drywall, or if it is determined that our existing warranty reserves together with anticipated recoveries from our insurance carrier and from other responsible parties and their insurance carriers are not sufficient to cover claims, losses or other issues related to Chinese drywall, then it is possible that we could incur additional costs or liabilities related to this issue that may have a material adverse effect on the results of our operations, financial position and cash flows.

Our income tax provision and other tax liabilities may be insufficient if taxing authorities initiate and are successful in asserting tax positions that are contrary to our position. Additionally, losses from operations in future reporting periods may require us to continue to adjust the valuation allowance against our deferred tax assets.

In the normal course of business, we are audited by various federal, state and local authorities regarding income tax matters. Significant judgment is required to determine our provision for income taxes and our liabilities for federal, state, local and other taxes. Our audits are in various stages of completion; however, no outcome for a particular audit can be determined with certainty prior to the conclusion of the audit, appeal and, in some cases, litigation process. Although we believe our approach to determining the appropriate tax treatment is supportable and in accordance with tax laws and regulations and relevant accounting literature, it is possible that the final tax authority will take a tax position that is materially different than ours. As each audit is conducted, adjustments, if any, are appropriately recorded in our consolidated financial statements in the period determined. Such differences could have a material adverse effect on our income tax provision or benefit, or other tax reserves, in the reporting period in which such determination is made and, consequently, on our results of operations, financial position and/or cash flows for such period.

Our net operating loss carryforwards could be substantially limited if we experience an ownership change as defined in the Internal Revenue Code.

In 2010 and 2011 , we generated net operating losses (NOLs) for tax purposes which could not be carried back to prior tax years, and we may generate additional NOLs in the future. Under federal tax laws, we can use our NOLs (and certain related tax credits) to offset ordinary income tax on our future taxable income for up to 20 years, after which they expire for such purposes. State NOL carryforwards may be used to offset future taxable income for a period of time ranging from 5 to 20 years, depending on the state, and begin to expire in 2012. Until they expire, we can carry forward our NOLs (and certain related tax credits) that we do not use in any particular year to offset income tax in future years. The benefits of our NOLs would be reduced or eliminated if we experience an ownership change, as determined under Section 382 of the Internal Revenue Code. A Section 382 ownership change occurs if a stockholder or a group of stockholders who are deemed to own at least 5% of our common stock increase their ownership by more than 50 percentage points over their lowest ownership percentage within a rolling three-year period. If an ownership change occurs, Section 382 would impose an annual limit on the amount of NOLs we can use to offset income tax equal to the product of the total value of our outstanding equity immediately prior to the ownership change (reduced by certain items specified in Section 382) and the federal long-term tax-exempt interest rate in effect for the month of the ownership change. A number of special and complex rules apply to calculating this annual limit.

While the complexity of Section 382 s provisions and the limited knowledge any public company has about the ownership of its publicly-traded stock make it difficult to determine whether an ownership change has occurred, we currently believe that an ownership change has not occurred. However, if an ownership change were to occur, the annual limit Section 382 may impose could result in some of our NOLs expiring unused. This may limit the future value of our federal NOL carryforward and deferred tax assets; however, these assets are only $70.2 million at December 31, 2011, and are currently subject to a full valuation allowance. Therefore, the annual limitation is not expected to have a material impact on our financial results. In 2009, we amended our articles of incorporation to enable us to nullify transactions creating additional 5% holders in an effort to mitigate the risk associated with ownership changes under Section 382. Such restrictions, however, may be waived by us, and there is uncertainty about whether such restrictions would be enforceable or effective under all circumstances.

Our ability to acquire and develop raw or partially finished lots may be negatively impacted if we are unable to secure additional performance bonds.

In connection with land development work we are required to complete on our raw or partially-finished land purchases, we oftentimes provide performance bonds or other assurances for the benefit of the respective municipalities or governmental authorities. These performance bonds provide assurance to the beneficiaries that the development will be completed, or that in case we do not perform, that funds from the bonds are available to finish such work. In the future, additional performance bonds may be difficult to obtain, or may be difficult to obtain on terms that are acceptable to us. The limited availability is due to the current state of the industry and the economy. Additionally, in recent years various surety providers have significantly reduced bonding capacities made available to the homebuilding industry. If we are unable to secure such required bonds, progress on affected projects may be delayed or halted or we may be required to expend additional cash to secure other forms of sureties which may adversely affect our financial position and ability to grow our operations.

The loss of key personnel may negatively impact us.

Our success largely depends on the continuing services of certain key employees and our ability to attract and retain qualified personnel. We have employment agreements with certain key employees who we believe possess valuable industry knowledge, experience and leadership abilities that would be difficult in the short term to replicate. The loss of the services of such key employees could harm our operations and business plans.

Failure to comply with laws and regulations by our employees or representatives may harm us.

We are required to comply with applicable laws and regulations that govern all aspects of our business including land acquisition, development, home construction, mortgage origination, sales and warranty. It is possible that individuals acting on our behalf could intentionally or unintentionally violate some of these laws and regulations. Although we endeavor to take immediate action if we become aware of such violations, we may incur fines or penalties as a result of these actions and our reputation with governmental agencies and our customers may be damaged. Further, other acts of bad judgement may also result in negative financial consequences.

Shortages in the availability of subcontract labor may delay construction schedules and increase our costs.

We conduct our construction operations only as a general contractor. Virtually all architectural, construction and development work is performed by unaffiliated third-party subcontractors. As a consequence, we depend on the continued availability of and satisfactory performance by these subcontractors for the design and construction of our homes and to provide related materials. Although we have not experienced such skilled labor shortages, we cannot be assured that there will be satisfactory performance by these unaffiliated third-party subcontractors, which could have a material adverse affect on our business.

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Our lack of geographic diversification could adversely affect us if the homebuilding industry in our market declines.

We have operations in Texas, Arizona, California, Nevada, Colorado, Florida, and North Carolina. Many of our geographic operations are located in regions that were most severely impacted by the homebuilding downturn. Although we have recently expanded our operations to new markets, our geographic diversification is still limited and could adversely impact us if the homebuilding business in our current markets should further decline, since we do not currently have a balancing opportunity in other geographic regions.

We experience fluctuations and variability in our operating results on a quarterly basis and, as a result, our historical performance may not be a meaningful indicator of future results.

We historically have experienced, and expect to continue to experience, variability in home sales and results of operations on a quarterly basis. As a result of such variability, our historical performance may not be a meaningful indicator of future results. Factors that contribute to this variability include:

- timing of home deliveries and land sales;
- the changing composition and mix of our asset portfolio;
- delays in construction schedules due to adverse weather, acts of God, reduced subcontractor availability and governmental restrictions;
- timing of write-offs and impairments ;
- conditions of the real estate market in areas where we operate and of the general economy;
- the cyclical nature of the homebuilding industry;
- changes in prevailing interest rates and the availability of mortgage financing;
- our ability to acquire additional land or options for additional land on acceptable terms; and
- costs and availability of materials and labor.

Our level of indebtedness may adversely affect our financial position and prevent us from fulfilling our debt obligations.

The homebuilding industry is capital intensive and requires significant up-front expenditures to secure land and pursue development and construction on such land. Accordingly, we incur substantial indebtedness to finance our homebuilding activities. At December, 31, 2011, we had approximately $606.4 million of indebtedness and $333.2 million of cash, restricted cash, and investments and securities. If we require working capital greater than that provided by operations and our current liquidity position, we may be required to seek additional capital in the form of equity or debt financing from a variety of potential sources, including bank financing and securities offerings. There can be no assurance we would be able to obtain such additional capital on terms acceptable to us, if at all. The level of our indebtedness could have important consequences to our stockholders, including the following:

our ability to obtain additional financing for working capital, capital expenditures, acquisitions or general corporate purposes could be impaired;

we could have to use a substantial portion of our cash flow from operations to pay interest and principal on our indebtedness, which would reduce the funds available to us for other purposes such as capital expenditures;

we have a moderate level of indebtedness and a lower volume of cash and cash equivalents than some of our competitors, which may put us at a competitive disadvantage and reduce our flexibility in planning for, or responding to, changing conditions in our industry, including increased competition; and

we may be more vulnerable to economic downturns and adverse developments in our business than some of our competitors.

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We expect to generate cash flow to pay our expenses and to pay the principal and interest on our indebtedness with cash flow from operations or from existing cash reserves. Our ability to meet our expenses thus depends, to a large extent, on our future performance, which will be affected by financial, business, economic and other factors. We will not be able to control many of these factors, such as economic conditions in the markets where we operate and pressure from competitors. If we do not have sufficient funds, we may be required to refinance all or part of our existing debt, sell assets or borrow additional funds. We cannot guarantee that we will be able to do so on terms acceptable to us, if at all. In addition, the terms of existing or future debt agreements may restrict us from pursuing any of these alternatives.

Our debt levels may place limits on our ability to comply with the terms of our debt and may restrict our ability to complete certain transactions.

The indentures for our senior and senior subordinated notes impose significant operating and financial restrictions on us. These restrictions limit our ability and the ability of our subsidiaries, among other things, to:

- incur additional indebtedness or liens;
- pay dividends or make other distributions;
- repurchase our stock;
- make acquisitions and investments (including investments in joint ventures); or
- consolidate, merge or sell all or substantially all of our assets.

A breach of any of our covenants or our inability to maintain the required financial ratios could limit our ability to incur additional debt.

Our ability to obtain third-party financing may be negatively affected by any downgrade of our credit rating from a rating agency

Although we do not currently have any short-term borrowing facilities, we consider the availability of third-party financing to be a key component of our long-term strategy to grow our business either through acquisitions or through internal expansion. As of December 31, 2011, our credit ratings were B+, B1 and B+ by Standard and Poor s Financial Services, Moody s Investor Services and Fitch Ratings, respectively, the three primary rating agencies. Any downgrades from these ratings may impact our ability in the future to obtain additional financing, or to obtain such financing at terms that are favorable to us and therefore, may adversely impact our future operations.

We may not be successful in future expansion and integrating future acquisitions.

We may consider growth or expansion of our operations in our current markets or in other areas of the country. Our expansion into new or existing markets could have a material adverse effect on our cash flows and/or profitability. The magnitude, timing and nature of any future expansion will depend on a number of factors, including suitable additional markets and/or acquisition candidates, the negotiation of acceptable terms, our financial capabilities and general economic and business conditions. New acquisitions may result in the incurrence of additional debt. Acquisitions also involve numerous risks, including difficulties in the assimilation of the acquired company s operations, the incurrence of unanticipated liabilities or expenses, the diversion of management s attention from other business concerns, risks of entering markets in which we have limited or no direct experience and the potential loss of key employees of the acquired company.

We are subject to extensive government regulations that could cause us to incur significant liabilities or restrict our business activities.

Regulatory requirements could cause us to incur significant liabilities and costs and could restrict our business activities. We are subject to local, state and federal statutes and rules regulating certain developmental matters, as well as building and site design. We are subject to various fees and charges of government authorities designed to defray the cost of providing certain governmental services and improvements. We may be subject to additional costs and delays or may be precluded entirely from building projects because of no-growth or slow-growth initiatives, building permit ordinances, building moratoriums, or similar government regulations that could be imposed in the future due to health, safety, climate, welfare or environmental concerns. We must also obtain licenses, permits and approvals from government agencies to engage in certain activities, the granting or receipt of which are beyond our control and could cause delays in our homebuilding projects.

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We are also subject to a variety of local, state and federal statutes, ordinances, rules and regulations concerning the protection of health and the environment. Environmental laws or permit restrictions may result in project delays, may cause substantial compliance and other costs and may prohibit or severely restrict development in certain environmentally sensitive regions or geographic areas. Environmental regulations can also have an adverse impact on the availability and price of certain raw materials, such as lumber.

In addition, there is a variety of new legislation being enacted, or considered for enactment at the federal, state and local level relating to energy and climate change. This legislation relates to items such as carbon dioxide emissions control and building codes that impose energy efficiency standards. New building code requirements that impose stricter energy efficiency standards could significantly increase our cost to construct homes. As climate change concerns continue to grow, legislation and regulations of this nature are expected to continue and become more costly to comply with. Similarly, energy-related initiatives affect a wide variety of companies throughout the United States and the world and because our operations are heavily dependent on significant amounts of raw materials, such as lumber, steel, and concrete, they could have an indirect adverse impact on our operations and profitability to the extent the manufacturers and suppliers of our materials are burdened with expensive cap and trade and similar energy related regulations.

Acts of war may seriously harm our business.

Acts of war or any outbreak or escalation of hostilities throughout the world may cause disruption to the economy, our company, our employees and our customers, which could impact our revenue, costs and expenses and financial condition.

Our ability to build Green technologies at a profitable price point may be replicated by other builders in the future, which could reduce our competitive advantage.

We believe we currently have a competitive advantage over other production homebuilders with the rollout of our Meritage Green technology. Our green communities offer a high level of energy-saving features included in the base price of our homes, and many of our other communities are engineered to add on optional solar features to further optimize energy savings. If other builders are able to replicate our green technologies and offer them at a similar price point, it could diminish our competitive advantage in the marketplace.

Information technology failures and data security breaches could harm our business.

We use information technology and other computer resources to carry out important operational and marketing activities as well as maintain our business records. Many of these resources are provided to us and/or maintained on our behalf by third-party service providers pursuant to agreements that specify certain security and service level standards. Although we and our service providers employ what we believe are adequate security, disaster recovery and other preventative and corrective measures, our ability to conduct our business may be impaired if these resources are compromised, degraded, damaged or fail, whether due to a virus or other harmful circumstance, intentional penetration or disruption of our information technology resources by a third party, natural disaster, hardware or software corruption or failure or error (including a failure of security controls incorporated into or applied to such hardware or software), telecommunications system failure, service provider error or failure, intentional or unintentional personnel actions (including the failure to follow our security protocols), or lost connectivity to our networked resources. A significant and extended disruption in the functioning of these resources could damage our reputation and cause us to lose customers, sales and revenue, result in the unintended public disclosure or the misappropriation of proprietary, personal and confidential information (including information about our homebuyers and business partners), and require us to incur significant expense to address and resolve these kinds of issues. The release of confidential information may also lead to litigation or other proceedings against us by affected individuals and/or business partners and/or by regulators, and the outcome of such proceedings, which could include penalties or fines, could have a material and adverse effect on our consolidated financial statements. In addition, the costs of maintaining adequate protection against such threats, depending on their evolution, pervasiveness and frequency and/or government-mandated standards or obligations regarding protective efforts, could be material to our consolidated financial statements.

Any of the above risk factors could have a material adverse effect on your investment in our bonds and common stock. As a result, you could lose some or all of your investment.

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Special Note of Caution Regarding Forward-Looking Statements

In passing the Private Securities Litigation Reform Act of 1995 (PSLRA), Congress encouraged public companies to make forward-looking statements by creating a safe-harbor to protect companies from securities law liability in connection with forward-looking statements. We intend to qualify both our written and oral forward-looking statements for protection under the PSLRA.

The words believe, expect, anticipate, forecast, plan, intend, may, will, should, could, estimate, and project and similar forward-looking statements, which speak only as of the date the statement was made. All statements we make other than statements of historical fact are forward-looking statements within the meaning of that term in Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Exchange Act. Forward-looking statements in this Annual Report include statements concerning our belief that we have ample liquidity; our intentions and the expected benefits of our Meritage Forward and Meritage Green strategies and initiatives as well as our land positioning strategies; our perceptions that the homebuilding market has stabilized; our expectations for 2012, including that we expect margin improvement in California; the extent and magnitude of our exposure to defective Chinese drywall and the sufficiency of our reserves relating thereto; our delivery of substantially all of our backlog existing as of year-end; management estimates regarding future impairments and joint venture exposure, including our exposure to joint ventures that are in default of their debt agreements; that we do not anticipate significant additional spending relating to Chinese drywall repair or claims; our positions and our expected outcome relating specifically to the litigation we are involved with concerning the South Edge/Inspirada joint venture; our intentions to not pay dividends; trends in Nevada as we wind down our operations there; the expected benefits of our call center operations; our ability to leverage our local market expertise in Florida to our new Tampa market; that we may use excess liquidity to repurchase our notes and common stock; the sustainability of our tax positions; whether certain guarantees relating to our joint ventures will be triggered and our belief that reimbursements due from lenders to our joint ventures will be repaid; expectations regarding our industry and our business into 2012 and beyond, and that we expect our cash expenditures may exceed our cash generated by operations as we expand our business; the demand for and the pricing of our homes; our land and lot acquisition strategy (including that we will redeploy cash to acquire well-positioned finished lots and that we may participate in joint ventures or opportunities outside of our existing markets if opportunities arise); that all of our option contracts initially entered into before the housing downturn have either been renegotiated or terminated; trends relating to cancellations and our general and administrative expenses; the sufficiency of our warranty reserves; demographic and other trends related to the homebuilding industry in general; the future supply of housing inventory; our expectation that existing guarantees, letters of credit and performance and surety bonds will not be drawn on; the adequacy of our insurance coverage and warranty reserves; the expected outcome of legal proceedings (including tax audits) we are involved in; the sufficiency of our capital resources to support our business strategy; our ability and willingness to acquire land under option or contract; the future impact of deferred tax assets or liabilities; the impact of new accounting standards and changes in accounting estimates; trends and expectations concerning sales prices, sales orders, cancellations, construction costs and gross margins and future home inventories; our future cash needs; the expected vesting periods of unrecognized compensation expense; trends and expectations relating to our community count and lot inventory; the impact of seasonality; and our future compliance with debt covenants and actions we may take with respect thereto.

Important factors currently known to management that could cause actual results to differ materially from those in forward-looking statements, and that could negatively affect our business are discussed in this report under the heading Risk Factors.

Forward-looking statements express expectations of future events. All forward-looking statements are inherently uncertain as they are based on various expectations and assumptions concerning future events and they are subject to numerous known and unknown risks and uncertainties that could cause actual events or results to differ materially from those projected. Due to these inherent uncertainties, the investment community is urged not to place undue reliance on forward-looking statements. In addition, we undertake no obligations to update or revise forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events or changes to projections over time. As a result of these and other factors, our stock and note prices may fluctuate dramatically.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Our corporate office is in a leased building located in Scottsdale, Arizona. The lease expires in March 2014.

We lease an aggregate of approximately 246,000 square feet of office space (of which approximately 86,000 square feet is currently subleased by us to third parties) in our markets for our operating divisions, corporate and executive offices.

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Item 3. Legal Proceedings

We are involved in various routine legal and regulatory proceedings, including, without limitation, claims and litigation alleging construction defects. In general, the proceedings are incidental to our business, and some are covered by insurance. With respect to the majority of pending litigation matters, our ultimate legal and financial responsibility, if any, cannot be estimated with certainty and, in most cases, any potential losses related to these matters are not considered probable. At December 31, 2011, we had approximately $10.2 million in accrued legal expenses and settlement costs related to warranty claims and litigation where our ultimate exposure is considered probable and the potential loss can be reasonably estimated. At December 31, 2011, we also had an additional $23.1 million of warranty costs reserves. Historically, most warranty claims and disputes are resolved prior to litigation. We believe there are not any pending legal or warranty matters that could have a material adverse impact upon our consolidated financial condition, results of operations or cash flows.

Joint Venture Litigation

Since 2008, we have been in litigation initiated by the lender group regarding a large Nevada-based land acquisition and unconsolidated development joint venture in which the lenders were seeking damages in two separate actions on the basis of enforcement of completion guarantees and other related claims (*JP Morgan Chase Bank, N.A. v. KB HOME Nevada, et al., U.S. District Court, District of Nevada* (Case No. 08-CV-01711 PMP consolidated)). Our interest in this joint venture was comparatively small, totaling 3.53%, but we have vigorously defended and otherwise sought resolution of these actions. We are the only builder joint venture partner to have fully performed its obligations with respect to takedowns of lots from the joint venture, having completed our first takedown in April 2007 and having tendered full performance of our second and final takedown in April 2008. The joint venture and the lender group rejected our tender of performance of our second and final takedown, and we contend, among other things, that the rejection by the joint venture and the lender group of our tender of full performance was wrongful and constituted a breach of contract and should release us of liability with respect to the takedown and extinguish or greatly reduce our exposure under all guarantees. Pursuant to the lenders request and stipulation of the parties, on January 23, 2012, the Court dismissed without prejuidice all of the lenders claims against Meritage in this consolidated lawsuit without prejudice (including the springing repayment guarantee discussed below).

On December 9, 2010, three of the lenders filed a petition seeking to place the venture into an involuntary bankruptcy. On June 6, 2011, we received a demand letter from the lenders, requesting full payment of $13.2 million the lenders claimed to be owed under the springing repayment guarantee, including past-due interest and penalties. The lenders claim that the involuntary bankruptcy filed by three of the lenders triggered the springing repayment guarantee. We do not believe the lenders have an enforceable position associated with their $13.2 million claim and do not believe we will be required to pay such amount because, among other reasons, the lenders breached their contract with us by refusing to accept the April 2008 tender of our performance and by refusing to release their lien in connection with our second and final takedown in this project and we do not believe the repayment guarantee was triggered by the lenders filing of the involuntary bankruptcy (JP Morgan Chase Bank, N.A. v. South Edge, LLC (Case No. 10-32968-bam)). As a result, on August 19, 2011, we filed a lawsuit against JP Morgan Chase Bank, NA (JP Morgan) in the Court of Common Pleas in Franklin County, Ohio (Case No. 11CVH0810353) regarding the repayment guarantee. In reaction to that lawsuit, on August 25, 2011, JP Morgan filed a lawsuit against us in the US District Court of Nevada regarding most of the same issues addressed in the Ohio litigation (Case No. 2: 11-CV-01364-PMP). On October 26, 2011, the Bankruptcy Court approved a plan pursuant to which the lenders have received all payment they are entitled to. The project has been conveyed to an entity owned by four of the co-venturers in the South Edge entity (KB Home, Toll Brothers, Pardee Homes and Beazer Homes) and pursuant to which the four co-venturer builders claim to have succeeded to the lenders repayment guarantee claim against Meritage.

In a separate lawsuit related to this venture, all members of the joint venture participated in an arbitration regarding their respective performance obligations in response to one of the members claims (the Focus Lawsuit). On July 6, 2010, the arbitration decision was issued, which denied the specific performance claim, but did award approximately $37 million of damages to one member on other claims. The parties involved jointly appealed the arbitration panel s decision (we have also appealed on independent grounds) to the United States Courts of Appeal for the Ninth Circuit, *Focus South Group, LLC, et al. v. KB HOME Nevada Inc, et al.* (Case No. 10-17562). We separately appealed this ruling because we believe the arbitration panel did not have the authority to award damages against us as the ruling included a specific finding that the action of the other builder members to defer takedowns (over our objection and our contrary vote), was wrongful and was the cause of the damages at issue. In connection with the bankruptcy proceedings, the four co-venturer builders settled with Focus and have taken an assignment of Focus arbitration award.

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As a result of the Bankruptcy Court plan and the related settlements between the four settling builders and the lenders and between the four settling builders and Focus, we anticipate that we will be litigating the repayment guarantee claim against JP Morgan and/or the four settling builders, and we will be litigating the arbitration appeal against the four settling builders.

In connection with these on-going legal proceedings, we have established reserves for amounts that we believe are appropriate for both potential settlements and legal costs. The amount we have reserved is less than the aggregate amount of our guarantees and our pro rata share of the damage claim awarded in the arbitration proceeding that is currently subject to appeal, because it takes into account: (i) defenses we believe we possess, many of which are unique to our position in the venture as the only performing builder venture partner, as well as (ii) claims we may have against our co-venturers and the lenders. Our 3.53% investment in the venture has been previously fully impaired. We do not believe that the ultimate disposition of these matters will have a material adverse affect on our financial condition.

Chinese Drywall Litigation

Owners of 17 Florida homes constructed by us are plaintiffs and have made claims against us in the pending Multi-District Litigation in the United States District Court, New Orleans, Louisiana, based on allegations that their homes contain defective Chinese drywall. We have entered into agreements with 12 of those homeowner plaintiffs, pursuant to which we either have or will repair their homes and be released from property damage liability associated with defective Chinese drywall in those homes. We have also been named as a defendant in an Omnibus Complaint filed on February 7, 2011 in the Multi-District Litigation in which two owners of homes constructed by Meritage in the Houston, Texas area contend their homes contain defective Chinese drywall. Among the approximately seven total homeowner plaintiffs in the Multi-District Litigation with whom we do not yet have a repair work authorization and release, their claims allege a variety of property and personal injury damages and seek legal and equitable relief, medical monitoring and legal fees. The remaining Chinese drywall warranty reserves we have accrued as of December 31, 2011 include costs anticipated to be incurred with the repair of these and other homes affected by defective Chinese drywall.

Item 4. Mine Safety Disclosures

Not applicable.

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PART II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Our common stock is listed on the New York Stock Exchange (NYSE) under the symbol MTH . The high and low sales prices per share of our common stock for the periods indicated, as reported by the NYSE, follow.

	September 30, 2011	September 30,	September 30, 2010	September 30,
Quarter Ended	**High**	**Low**	**High**	**Low**
March 31	$ 27.42	$ 22.21	$ 23.73	$ 19.30
June 30	$ 26.65	$ 20.90	$ 25.44	$ 16.11
September 30	$ 23.91	$ 14.50	$ 20.25	$ 15.19
December 31	$ 23.50	$ 13.68	$ 23.48	$ 17.73

The following Performance Graph and related information shall not be deemed to be soliciting material or to be filed with the Securities and Exchange Commission, nor shall such information be incorporated by reference into any filing under the Securities Act of 1933 or Securities Exchange Act of 1934, each as amended, except to the extent that we specifically incorporate it by reference into such filing.

	September 30, 2006	September 30, 2007	September 30, 2008	September 30, 2009	September 30, 2010	September 30, 2011
Meritage Homes Corp	100.00	30.53	25.50	40.51	46.52	48.60
S&P 500 Index	100.00	103.67	64.55	78.82	88.72	88.97
Dow Jones US Home Construction Index	100.00	44.24	30.11	34.92	35.08	33.73

The above graph compares the five-year total return of our common stock with the S&P 500 Index and the Dow Jones US Home Construction Index. The graph assumes 100 invested as of December 31, 2006 in Meritage Common Stock the S&P 500 Index and the Dow Jones US Home Construction Index, and the re-investment of all dividends. The performance of our common stock depicted in the graphs is not indicative of future performance.

On February 23, 2012, there were approximately 284 owners of record and approximately 9,600 beneficial owners of common stock.

The transfer agent for our common stock is BNY Mellon Shareowner Services, 480 Washington Blvd, Jersey City, NJ 07310 *(www.bnymellon.com/shareowner/equity access).*

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Historically, we have not declared cash dividends, nor do we intend to declare cash dividends in the foreseeable future. We plan to retain our earnings to finance the continuing development of the business. Future cash dividends, if any, will depend upon our financial condition, results of operations, capital requirements, compliance with certain restrictive debt covenants, as well as other factors considered relevant by our Board of Directors. Our senior and senior subordinated note indentures contain restrictions on the payment of cash dividends. See Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources and Note 4 Senior and Senior Subordinated Notes and Letters of Credit Facilities, in the accompanying consolidated financial statements.

Reference is made to Note 7 in the accompanying consolidated financial statements for a description of our compensation plans.

Issuer Purchases of Equity Securities

We did not acquire any shares of our common stock during the twelve months ended December 31, 2011.

On February 21, 2006, we announced that the Board of Directors approved a stock repurchase program, authorizing the expenditure of up to $100 million to repurchase shares of our common stock. In August 2006, the Board of Directors authorized an additional $100 million under this program. There is no stated expiration date for this program. As of December 31, 2011, we had approximately $130.2 million of the authorized amount available to repurchase shares under this program. We have no plans to purchase additional shares under this program in the foreseeable future.

Executive Officers of the Registrant

The names, ages, positions and business experience of our executive officers are listed below (all ages are as of March 1, 2012). Other than the terms and provisions of various Employment and Change of Control Agreements between the Company and the listed officers, there are no understandings between any of our executive officers and any other person pursuant to which any executive officer was selected to his office.

Name	**September 30,** **Age**	**September 30,** **Position**
Steven J. Hilton	50	Chairman of the Board and Chief Executive Officer
Larry W. Seay	56	Chief Financial Officer, Executive Vice President
C. Timothy White	51	General Counsel, Executive Vice President and Secretary
Steven M. Davis	53	Chief Operating Officer, Executive Vice President

Steven J. Hilton co-founded Monterey Homes in 1985, which merged with our predecessor in December 1996. Mr. Hilton served as Co-Chairman and CEO from July 1997 to May 2006 and has been the Chairman and Chief Executive Officer since May 2006.

Larry W. Seay has been Chief Financial Officer since December 1996 and was appointed Executive Vice President in October 2005.

C. Timothy White has been General Counsel, Executive Vice President and Secretary since October 2005 and served on our Board of Directors from December 1996 until October 2005.

Steven M. Davis has been Chief Operating Officer, Executive Vice President since December 2008. From October 2006 to December 2008, Mr. Davis was Executive Vice President of National Homebuilding Operations. From 2000 to September 2006, Mr. Davis was employed by KB Home as a Regional General Manager, with various other management roles at KB Home from 1995 to 2000.

Each member of our Executive management team has in excess of 25 years of residential real estate experience.

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Item 6. Selected Financial Data

The following table presents selected historical consolidated financial and operating data of Meritage Homes Corporation and subsidiaries as of and for each of the last five years ended December 31, 2011. The financial data has been derived from our audited consolidated financial statements and related notes for the periods presented. This table should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and related notes included elsewhere in this Annual Report. These historical results may not be indicative of future results.

	September 30,	September 30,	September 30,	September 30,	September 30,
	Historical Consolidated Financial Data Years Ended December 31, ($ in thousands, except per share amounts)				
	2011	2010	2009	2008	2007
Statement of Operations Data:					
Total closing revenue	$ 861,244	$ 941,656	$ 970,313	$ 1,523,068	$ 2,343,594
Total cost of closings	(704,812)	(767,509)	(840,046)	(1,322,544)	(1,990,190)
Impairments	(15,324)	(6,451)	(126,216)	(237,439)	(340,358)
Gross profit/(loss)	141,108	167,696	4,051	(36,915)	13,046
Commissions and other sales costs	(74,912)	(76,798)	(78,683)	(136,860)	(196,464)
General and administrative expenses	(64,184)	(59,784)	(59,461)	(64,793)	(104,745)
Goodwill and intangible asset impairments	0	0	0	(1,133)	(130,490)
Earnings/(loss) from unconsolidated entities, net (1)	5,849	5,243	4,013	(17,038)	(40,229)
Interest expense	(30,399)	(33,722)	(36,531)	(23,653)	(6,745)
(Loss)/gain on extinguishment of debt	0	(3,454)	9,390	0	0
Other income, net	2,162	3,303	2,422	4,426	9,145
(Loss)/earnings before income taxes	(20,376)	2,484	(154,799)	(275,966)	(456,482)
(Provision for)/benefit from income taxes	(730)	4,666	88,343	(15,969)	167,631
Net (loss)/earnings	$ (21,106)	$ 7,150	$ (66,456)	$ (291,935)	$ (288,851)
(Loss)/earnings per common share:					
Basic	$ (0.65)	$ 0.22	$ (2.12)	$ (9.95)	$ (11.01)
Diluted	$ (0.65)	$ 0.22	$ (2.12)	$ (9.95)	$ (11.01)
Balance Sheet Data (December 31):					
Cash, cash equivalents, investments and securities and restricted cash	$ 333,187	$ 412,642	$ 391,378	$ 205,923	$ 27,677
Real estate	$ 815,425	$ 738,928	$ 675,037	$ 859,305	$ 1,267,879
Total assets	$ 1,221,378	$ 1,224,938	$ 1,242,667	$ 1,326,249	$ 1,748,381
Senior and senior subordinated notes, loans payable and other borrowings	$ 606,409	$ 605,780	$ 605,009	$ 628,968	$ 729,875
Total liabilities	$ 732,466	$ 724,943	$ 757,242	$ 799,043	$ 1,018,217
Stockholders equity	$ 488,912	$ 499,995	$ 485,425	$ 527,206	$ 730,164
Cash Flow Data:					
Cash (used in)/provided by:					
Operating activities	$ (74,136)	$ 32,551	$ 184,074	$ 199,829	$ (20,613)
Investing activities	$ 141,182	$ (174,515)	$ (145,419)	$ (23,263)	$ (9,677)
Financing activities	$ 2,613	$ (3,414)	$ 4,753	$ 1,680	$ 1,257

(1) Earnings/(loss) from unconsolidated entities in 2011, 2010, 2009, 2008 and 2007 includes $0, $300,000, $2.8 million, $26.0 million and $57.9 million, respectively, of joint venture investment impairments. Refer to Notes 1 and 2 of our consolidated financial statements for more detail.

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Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

Overview and Outlook

Industry Conditions

While the economy and homebuilding markets continued to be challenged during 2011, we have recently seen indications that demand for new homes is stabilizing in some of our markets. Therefore, despite above-average foreclosure and unemployment rates, increased interest and traffic in our communities and homes have resulted in improving sales in certain parts of the country. The first half of 2011 was comparatively less successful than the first half of 2010, mostly due to an elevated level of 2010 closings as a result of the federal homebuyer tax credit program, but the second half of 2011 showed comparative improvement, as our sales units increased as well as our average sales prices and backlog year over year. We finished 2011 on a positive note by posting gains in the fourth quarter in many of our key operating metrics and we continued to focus on generating greater profit on each sale while controlling our overhead expense. We believe a full economic and real estate recovery will continue to be an uneven process and will not fully materialize until there is broad, sustainable employment and the consumer confidence returns. We ended 2011 with higher expectations for early 2012 as we enter the new year with higher levels of backlog than last year.

Summary Company Results

Total home closing revenue was $860.9 million for the year ended December 31, 2011, decreasing 8.5% from $940.4 million for 2010 and 10.6% from $962.8 million in 2009. We incurred a net loss for 2011 of $21.1 million compared to net income of $7.2 million in 2010 and a loss of $66.5 million in 2009. Full-year 2010 home closing revenue and net income benefitted from closings that spiked the first half of the year because of the federal homebuyer tax credit program. There was no such benefit in 2011, resulting in difficult year-over-year comparisons. Our 2011 results include $15.3 million of real estate-related impairments. In 2010, results included $6.5 million of real estate-related impairments, $3.5 million loss from early extinguishment of debt, and a $4.7 million tax benefit. In 2009, we incurred $126.2 million of real estate-related impairments, $9.4 million gain from early extinguishment of debt, and had an $88.3 million tax benefit relating to reversal of our deferred tax valuation allowance.

At December 31, 2011, our backlog of $248.9 million was up 23.3% from $201.8 million at December 31, 2010. Our December 31, 2009 backlog was $287.5 million, higher comparatively, largely due to the federal homebuyer tax credit program that translated into higher closing units and dollars in the first half of 2010, as discussed above. Increased home sales per community and a higher active community count in the second half of 2011 were primarily responsible for the increase in ending 2011 backlog over 2010. Our average sales price for homes in backlog increased to $272,000, up 4.9% from $259,400 at December 31, 2010, and up 3.6% from $262,600 at December 31, 2009, primarily due to mix of homes shifting to higher-priced markets, and more sought-after closer-in locations. Our cancellation rate on sales orders as a percentage of gross sales decreased in 2011 to 17.0%, down from 20.9% and 24.3%, respectively, for the years ended December 31, 2010 and 2009. We believe the combination of these positive factors reflect some stabilization of home prices and consumer confidence during the second half of the year and as we enter 2012.

Company Actions and Positioning

Throughout this continued difficult homebuilding market, we have remained focused on our main goals: return to and maintain profitability, and strengthen our balance sheet. In order to meet these goals, over the past several years we began and continue to execute on the following initiatives:

- Utilizing our enhanced market research to capitalize on the knowledge of our buyers demands in each community, tailoring our pricing, product and amenities offered;

- Continuing to innovate and promote the Meritage Green energy efficiency program, so that every new home we construct, at a minimum, meets current ENERGY STAR® standards, including the construction of our first net-zero production home that produces as much energy as it uses annually;

Managing our total lot supply and future growth of our communities by actively contracting new well-priced lots in better-located submarkets;

Adapting sales and marketing efforts to generate additional traffic and compete with resale homes including a marketing call center as a resource for our buyers;

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- Renegotiating construction costs with our subcontractors where possible;
- Exercising tight control over cash flows;
- Monitoring our customer satisfaction scores and working toward improving them based on the results of the surveys;
- Executing our company-wide operating strategy, Meritage Forward, and the roll-out of associated initiatives such as the Simply Smart Series^{TM} and 99-day closing guarantee; and
- Maintaining consolidated overhead functions at all of our divisions and corporate offices to hold down general and administrative cost burden.

Additionally, we are evaluating opportunities for expansion into new markets that have been less impacted by the homebuilding downturn over the past several years. We are looking to redeploy our capital into projects both within our geographic footprint and through entry into new markets. To that end, in April 2011 we announced our entry into the Raleigh-Durham, North Carolina market and in December 2011 announced our entry into the Tampa, Florida market.

We believe that the investments in our new communities, markets and product offerings create a differentiated strategy that has lessened the impact of the current economic conditions and improved our operating leverage. Throughout 2011, we opened 78 new communities while closing out 72 communities, ending the year with 157 active communities. We continue to believe in the long-term viability of the domestic homebuilding market and that builders with in-depth industry expertise, successful business and operational models and well-priced land positions will benefit when the housing market recovers.

In a response to our strategy to take advantage of capital-raising opportunities we have completed the following transactions:

- During 2010, we completed an offering of $200 million aggregate principal amount of 7.15% senior notes due 2020. The notes were issued at 97.567% of par value to yield 7.50%. Concurrent with the issuance of the 2020 notes, we purchased all of our $130 million 7.0% senior notes maturing 2014 and $65 million of our 6.25% senior notes maturing 2015. In connection with these transactions, we recorded a $3.5 million loss on early extinguishment of debt, which is reflected in our statement of operations for the year ended December 31, 2010. This transaction pushed out our earliest maturity from 2014 to 2015 and reduced our 2015 maturity by $65 million.
- During 2009 we retired $24.1 million of our 7.731% senior subordinated notes maturing in 2017 by issuing approximately 783,000 shares of our common stock in privately negotiated transactions at a 41% average discount from the face value of the notes, resulting in a $9.4 million gain on early extinguishment of debt for the year ended December 31, 2009.

We continue to closely monitor capital markets and our liquidity and will undertake additional transactions if and when we deem most prudent.

Critical Accounting Policies

We have established various accounting policies that govern the application of United States generally accepted accounting principles (GAAP) in the preparation and presentation of our consolidated financial statements. Our significant accounting policies are described in Note 1 of the consolidated financial statements included in this Form 10-K. Certain of these policies involve significant judgments, assumptions and estimates by management that may have a material impact on the carrying value of certain assets and liabilities, and revenue and costs. We are subject to uncertainties such as the impact of future events, economic, environmental and political factors and changes in our business environment; therefore, actual results could differ from these estimates. Accordingly, the accounting estimates used in the preparation of our financial statements will change as new events occur, as more experience is acquired, as additional information is obtained and as our operating environment changes. Changes in estimates are revised when circumstances warrant. Such changes in estimates and refinements in methodologies are reflected in our reported results of operations and, if material, the effects of changes in estimates are disclosed in the notes to our consolidated financial statements. The judgments, assumptions and estimates we use and believe to be critical to our business are based on historical experience, knowledge of the accounts and other factors, which we believe to be reasonable under the circumstances. Because of the nature of the judgments and assumptions we have made, actual results may differ from these judgments and estimates and could have a material impact on the carrying values of assets and liabilities and the results of our operations.

The accounting policies that we deem most critical to us and involve the most difficult, subjective or complex judgments are as follows:

Revenue Recognition

We recognize revenue from a home sale when title passes to the homeowner, the homeowner s initial and continuing investment is adequate to demonstrate a commitment to pay for the home, the receivable, if any, from the homeowner is not subject to future subordination and we do not have a substantial continuing involvement with the sold home. These conditions are typically achieved when a home closes.

Revenue from land sales is recognized when a significant down payment is received, the earnings process is relatively complete, title passes and collectability of the receivable is reasonably assured. Although there is limited subjectivity in this accounting policy, we have designated revenue recognition as a critical accounting policy due to the significance of this balance in our statements of operations.

Real Estate

Real estate is stated at cost unless the community or land is determined to be impaired, at which point the inventory is written down to fair value as required by Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 360-10, *Property, Plant and Equipment.* Inventory includes the costs of land acquisition, land development and home construction, capitalized interest, real estate taxes, direct overhead costs incurred during development and home construction that benefit the entire community, less impairments, if any. Land and development costs are typically allocated and transferred to homes under construction when home construction begins. Home construction costs are accumulated on a per-home basis. Cost of home closings includes the specific construction costs of the home and all related allocated land acquisition, land development and other common costs (both incurred and estimated to be incurred) based upon the total number of homes expected to be closed in each community or phase. Any changes to the estimated total development costs of a community or phase are allocated to the remaining homes in the community or phase. When a home closes, we may have incurred costs for goods and services that have not yet been paid. Therefore, an accrual to capture such obligations is recorded in connection with the home closing and charged directly to cost of sales.

Typically, an entitled community s life cycle ranges from three to five years, commencing with the acquisition of the land, continuing through the land development phase and concluding with the sale, construction and closing of the homes. Actual community lives will vary based on the size of the community, the absorption rates and whether the land purchased was raw land or finished lots. Master-planned communities encompassing several phases and super-block land parcels may have significantly longer lives and projects involving smaller finished lot purchases may be significantly shorter. Additionally, the current slow-down in the housing market has negatively impacted our sales pace, thereby extending the lives of certain communities.

All of our land inventory and related real estate assets are reviewed for recoverability at least quarterly, or more frequently if impairment indicators are present, as our inventory is considered long-lived in accordance with U.S. generally accepted accounting principles (GAAP). If an asset is deemed not recoverable, we record an impairment charge to the extent the fair value of such assets is less than their carrying amounts. Our determination of fair value is based on projections and estimates. Changes in these expectations may lead to a change in the outcome of our impairment analysis and actual results may also differ from our assumptions. Our analysis is completed at a community level with each community or land parcel evaluated individually. We pay particular attention to communities experiencing a larger-than-anticipated reduction in their absorption rates or averages sales prices or where gross margins are trending lower than anticipated. For those assets deemed to be impaired, the impairment to be recognized is measured by the amount by which the assets carrying balance exceeds their fair value. The impairment of a community is allocated to each lot on a straight-line basis.

Existing and continuing communities. When projections for the remaining income expected to be earned from existing communities are no longer positive, the underlying real estate assets are not deemed fully recoverable, and further analysis is performed to determine the required impairment. The fair value of the community s assets is determined using either a discounted cash flow model for projects we intend to build out or a market-based approach for projects to be sold. If our assets are not deemed fully recoverable, impairments are charged to cost of home closings in the period during which it is determined that the fair value is less than the assets carrying amount. If a market-based approach is used, we determine fair value based on recent comparable purchase and sale activity in the local market, adjusted for known variances as determined by our knowledge of the region and general real estate expertise. If a discounted cash flow approach is used, we compute fair value based on a proprietary model. Our key estimates in deriving fair value under our cash flow model are (i) home selling prices in the community

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adjusted for current and expected sales discounts and incentives, (ii) costs related to the community both land development and home construction including costs spent to date and budgeted remaining costs to spend, (iii) projected sales absorption rates, reflecting any product mix change strategies implemented to stimulate the sales pace and expected cancellation rates, (iv) alternative land uses including disposition of all or a portion of the land owned and (v) our discount rate, which is currently 14-16% and varies based on the perceived risk inherent in the community s other cash flow assumptions. These assumptions vary widely across different communities and geographies and are largely dependent on local market conditions. Community-level factors that may impact our key estimates include:

- The presence and significance of local competitors, including their offered product type and competitive actions;
- Economic and related demographic conditions for the population of the surrounding community;
- Desirability of the particular community, including unique amenities or other favorable or unfavorable attributes; and
- Existing home inventory supplies, including foreclosures and short sales.

These local circumstances may significantly impact our assumptions and the resulting computation of fair value, and are, therefore, closely evaluated by our division personnel in their creation of the discounted cash flow models. The models are also evaluated by regional and corporate personnel for consistency and integration, as decisions that affect pricing or absorption at one community may have resulting consequences for neighboring communities. We typically do not project market improvements in our discounted cash flow models, but may do so in limited circumstances in the latter years of a long-lived community. In certain cases, we may elect to stop development and/or marketing of an existing community (mothball) if we believe the economic performance of the community would be maximized by deferring development for a period of time to allow market conditions to improve. The decision may be based on financial and/or operational metrics. If we decide to mothball a project and its carrying value is not deemed recoverable, we will impair it to its fair value as discussed above and then cease future development activity until such a time where management believes that market conditions will improve and economic performance will be maximized. No costs are capitalized to communities that are designated as mothball. Quarterly, we review all communities, including mothballed communities, for potential impairments.

For our land held for future development and our mothballed communities, our inventory assessments typically include significant estimates regarding future performance, including the timing of development, the product to be offered, sales rates and selling prices of the product when the community is anticipated to open for sales, and the projected costs to develop and construct the community. We evaluate various factors to develop our forecasts, including the availability of and demand for homes and finished lots within the marketplace, historical, current and future sales trends, and other third-party data, if available. Based on these factors, we reach conclusions for future performance based on our judgment.

Option deposits and pre-acquisition costs: We also evaluate assets associated with future communities for impairments on a quarterly basis. Using similar techniques described in the existing and continuing communities section above, we determine if the income to be generated by our future communities are acceptable to us. If the projections indicate that a community is still meeting our internal investment guidelines and is generating a profit, those assets are determined to be fully recoverable and no impairments are required. In cases where we decide to abandon the project, we will fully impair all assets related to such project and will expense and accrue any additional costs that we are contractually obligated to incur. In certain circumstances, we may also elect to continue with a project because it is expected to generate positive future cash flows, even though it may not be generating an accounting profit, or because of other strategic factors. In such cases, we will impair our pre-acquisition costs and deposits, as necessary, to record an impairment to bring the book value to fair value.

Due to the complexity and subjectivity of these fair value computations, as well as the significance of associated impairments to our financial statements for the past several years, we have concluded that the valuation of our real-estate and associated assets is a critical accounting policy.

During 2011, we recorded $12.6 million of such impairment charges related to our home and land inventories. Additionally, we wrote off approximately $2.8 million of deposits and pre-acquisition costs relating to projects that were no longer economically feasible. Refer to Note 2 of these consolidated financial statements in this Annual Report on Form 10-K for further discussion regarding these impairments and the associated remaining fair values of impaired communities.

The impairment charges were based on our fair value calculations, which are affected by current market conditions, assumptions and expectations, all of which are highly subjective and may differ significantly from actual results if market conditions change.

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Due to the volume of possible outcomes that can be generated from changes in the various model inputs for each community, we do not believe it is possible to create a sensitivity analysis that can provide meaningful information for the users of our financial statements.

Warranty Reserves

We use subcontractors for nearly all aspects of home construction. Although our subcontractors are generally required to repair and replace any product or labor defects, we are, during applicable warranty periods, ultimately responsible to the homeowner for making such repairs. As such, warranty reserves are recorded to cover our exposure to absorb the costs for materials and labor not expected to be covered by our subcontractors to the extent they relate to warranty-type claims subsequent to the delivery of a home to the homeowner. Reserves are reviewed on a regular basis and, with the assistance of an actuary for the structural related warranty, we determine their sufficiency based on our and industry-wide historical data and trends. These reserves are subject to variability due to uncertainties regarding structural defect claims for the products we build, the markets in which we build, claim settlement history, insurance and legal interpretations, among other factors.

At December 31, 2011, our warranty reserve was $23.1 million, reflecting an accrual of 0.2% to 0.7% of a home s sale price depending on our loss history in the geographic area in which the home was built. A 10% increase in our warranty reserve rate would have increased our accrual and corresponding cost of sales by approximately $669,000 in 2011. We recorded a $2.6 million favorable adjustment to our reserve in 2011 based on historical trends of actual claims paid and our success in recovery of expended amounts. While we believe that the warranty reserve is sufficient to cover our projected costs, there can be no assurances that historical data and trends will accurately predict our actual warranty costs. Furthermore, there can be no assurances that future economic or financial developments might not lead to a significant change in the reserve.

Off-Balance Sheet Arrangements

Historically, we have invested in entities that acquire and develop land for sale to us in connection with our homebuilding operations or for sale to third parties. Our partners generally are unaffiliated homebuilders, land sellers and financial or other strategic partners. We currently are a member of only two such active land joint ventures. All entities through which we acquire and develop land are accounted for by either the cost or the equity method of accounting where the criteria for consolidation have not been met as set forth in ASC 810-10, *Consolidation* (ASC 810-10). We record our investments in these entities in our consolidated balance sheets as Investments in unconsolidated entities and our pro rata share of the entities earnings or losses in our consolidated statements of earnings as Earnings/(loss) from unconsolidated entities, net.

In order to determine if we should consolidate equity-basis joint ventures, we determine if the ventures are VIEs and if we are the primary beneficiary of the unconsolidated entity. Factors considered in our determination include our ability to control the activities of the entity that most significantly impact its economic performance, and in cases where we do control such activities, if we also are expected to absorb the majority of the expected losses or expected gains of the entity. For those entities where we are deemed the primary beneficiary, we consolidate the investment in our financial statements in accordance with ASC 810-10.

We enter into option or purchase agreements to acquire land or lots, for which we generally pay non-refundable deposits. We also analyze these agreements under ASC 810-10 to determine whether we are the primary beneficiary of the variable interest entity (VIE), if applicable, using a similar analysis, as noted above. If we are deemed to be the primary beneficiary of the VIE, we will consolidate the VIE in our consolidated financial statements. See Note 3 in the accompanying financial statements for additional information related to our off-balance-sheet arrangements. In cases where we are the primary beneficiary, even though we do not have title to such land, we are required to consolidate these purchase/option agreements and reflect such assets and liabilities as Real estate not owned in our consolidated balance sheets. The liabilities related to consolidated VIEs are excluded from our debt covenant calculations.

Valuation of Deferred Tax Assets

We account for income taxes using the asset and liability method, which requires that deferred tax assets and liabilities be recognized based on future tax consequences of both temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply in the years in which the temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in earnings in the period when the changes are enacted.

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In accordance with ASC 740-10, *Income Taxes*, we evaluate our deferred tax assets, including the benefit from NOLs, to determine if a valuation allowance is required. Companies must assess, using significant judgments, whether a valuation allowance should be established based on the consideration of all available evidence using a more likely than not standard with significant weight being given to evidence that can be objectively verified. This assessment considers, among other matters, the nature, frequency and severity of current and cumulative losses, forecasts of future profitability, the length of statutory carryforward periods, our experience with operating losses and our experience of utilizing tax credit carryforwards and tax planning alternatives. Based upon a review of all available evidence, we recorded a full valuation allowance against our deferred tax assets during 2008. We continue to maintain a full non-cash valuation allowance against the entire amount of our remaining net deferred tax assets at December 31, 2011 as we have determined that the weight of the negative evidence exceeds that of the positive evidence and it continues to be more likely than not that we will not be able to utilize all of our deferred tax assets and NOL carryovers.

At December 31, 2011 and 2010, we had a valuation allowance of $94.1 million ($70.2 million federal and $23.9 million state) and $90.0 million ($63.4 million federal and $26.6 million state), respectively, against deferred tax assets which include the tax benefit from NOL carryovers. Our future deferred tax asset realization depends on sufficient taxable income in the carryforward periods under existing tax laws. Federal net operating loss carryforwards may be used to offset future taxable income for 20 years and expire in 2030. State net operating loss carryforwards may be used to offset future taxable income for a period of time ranging from 5 to 20 years, depending on the state, and begin to expire in 2012. Deferred tax assets include tax-effected federal and state net operating loss carryforwards of $32.1 million and $25.6 million in 2011 and 2010, respectively. On an ongoing basis, we will continue to review all available evidence to determine if and when we expect to realize our deferred tax assets and NOL carryovers.

Share-Based Payments

We have stock options and restricted common stock units (nonvested shares) outstanding under our stock compensation plan. Per the terms of the plan, the exercise price of our stock options may not be less than the closing market value of our common stock on the date of grant, nor may options granted under the plans be exercised within one year from the date of the grant. After one year, exercises are permitted in pre-determined installments based upon a vesting schedule established at the time of grant. Each stock option expires on a date determined at the time of the grant, but not to exceed seven years from the date of the grant. Our restricted stock generally vests on a pro-rata basis over either three or five years.

The calculation of employee compensation expense involves estimates that require management judgments. These estimates include determining the value of each of our stock options on the date of grant using a Black-Scholes option-pricing model discussed in Note 7 in the accompanying consolidated financial statements. The fair value of our stock options, which typically vest ratably over a five-year period, is determined at the time of grant and is expensed on a straight-line basis over the vesting life of the options. Expected volatility is based on a composite of historical volatility of our stock and implied volatility from our traded options. The risk-free rate for periods within the contractual life of the stock option award is based on the rate of a zero-coupon Treasury bond on the date the stock option is granted with a maturity equal to the expected term of the stock option. We use historical data to estimate stock option exercises and forfeitures within our valuation model. The expected life of our stock option awards is derived from historical experience under our share-based payment plans and represents the period of time that we expect our stock options to be outstanding. A 10% decrease in our forfeiture rate would have increased our stock compensation by approximately $329,000 in 2011.

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Home Closing Revenue, Home Orders and Order Backlog Segment Analysis

The tables provided below show operating and financial data regarding our homebuilding activities (dollars in thousands).

	September 30, Years Ended December 31, 2011	September 30, 2010	September 30, Year Over Year Chg $	September 30, Chg %
Home Closing Revenue				
Total				
Dollars	$ 860,884	$ 940,406	$ (79,522)	(8.5)%
Homes closed	3,268	3,700	(432)	(11.7)%
Average sales price	$ 263.4	$ 254.2	$ 9.2	3.6%
West Region				
California				
Dollars	$ 120,319	$ 147,194	$ (26,875)	(18.3)%
Homes closed	355	417	(62)	(14.9)%
Average sales price	$ 338.9	$ 353.0	$ (14.1)	(4.0)%
Nevada				
Dollars	$ 12,593	$ 16,006	$ (3,413)	(21.3)%
Homes closed	59	81	(22)	(27.2)%
Average sales price	$ 213.4	$ 197.6	$ 15.8	8.0%
West Region Totals				
Dollars	$ 132,912	$ 163,200	$ (30,288)	(18.6)%
Homes closed	414	498	(84)	(16.9)%
Average sales price	$ 321.0	$ 327.7	$ (6.7)	(2.0)%
Central Region				
Arizona				
Dollars	$ 150,258	$ 156,117	$ (5,859)	(3.8)%
Homes closed	594	700	(106)	(15.1)%
Average sales price	$ 253.0	$ 223.0	$ 30.0	13.5%
Texas				
Dollars	$ 395,278	$ 487,797	$ (92,519)	(19.0)%
Homes closed	1,660	2,028	(368)	(18.1)%
Average sales price	$ 238.1	$ 240.5	$ (2.4)	(1.0)%
Colorado				
Dollars	$ 83,095	$ 48,820	$ 34,275	70.2%
Homes closed	258	162	96	59.3%
Average sales price	$ 322.1	$ 301.4	$ 20.7	6.9%
Central Region Totals				
Dollars	$ 628,631	$ 692,734	$ (64,103)	(9.3)%
Homes closed	2,512	2,890	(378)	(13.1)%
Average sales price	$ 250.3	$ 239.7	$ 10.6	4.4%
East Region				
North Carolina				
Dollars	N/A	N/A	N/A	N/A

Homes closed		N/A		N/A		N/A	N/A
Average sales price		N/A		N/A		N/A	N/A
Florida							
Dollars	$	99,341	$	84,472	$	14,869	17.6%
Homes closed		342		312		30	9.6%
Average sales price	$	290.5	$	270.7	$	19.8	7.3%
East Region Totals							
Dollars	$	99,341	$	84,472	$	14,869	17.6%
Homes closed		342		312		30	9.6%
Average sales price	$	290.5	$	270.7	$	19.8	7.3%

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	September 30,	September 30,	September 30,	September 30,