Meritage Homes CORP
Form 10-Q
November 07, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2006

or

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

Commission File Number 1-9977

MERITAGE HOMES CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

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

17851 North 85th Street, Suite 300	
Scottsdale, Arizona	**85255**
(Address of Principal Executive Offices)	(Zip Code)

(480) 609-3330

(Registrant s Telephone Number, Including Area Code)

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

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

Large Accelerated Filer x **Accelerated Filer o** **Non-Accelerated Filer o**
Indicate by a checkmark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No x

Common shares outstanding as of November 2, 2006: 26,121,016.

MERITAGE HOMES CORPORATION

FORM 10-Q FOR THE QUARTER ENDED SEPTEMBER 30, 2006

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

MERITAGE HOMES CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share amounts)

	September 30, 2006 (unaudited)	December 31, 2005
Assets:		
Real estate	$ 1,577,169	$ 1,392,267
Cash and cash equivalents	75,436	65,812
Deposits on real estate under option or contract	194,644	167,040
Receivables	74,104	60,745
Goodwill	129,800	130,222
Intangibles, net	13,055	14,029
Property and equipment, net	40,416	36,239
Prepaid expenses and other assets	31,004	16,289
Investments in unconsolidated entities	108,149	88,714
Total assets	$ 2,243,777	$ 1,971,357
Liabilities:		
Accounts payable	$ 119,488	$ 140,789
Accrued liabilities	265,242	290,275
Home sale deposits	57,281	76,299
Deferred tax liability, net	18,875	20,865
Loans payable and other borrowings	309,416	112,398
Senior notes	478,594	479,726
Total liabilities	1,248,896	1,120,352
Stockholders Equity:		
Common stock, par value $0.01. Authorized 125,000,000 shares at September 30, 2006, and 50,000,000 shares at December 31, 2005; issued and outstanding 34,009,184 and 33,112,358 shares at September 30, 2006 and December 31, 2005, respectively	340	331
Additional paid-in capital	329,725	296,804
Retained earnings	853,578	637,248
Treasury stock at cost, 7,891,068 and 5,935,068 shares at September 30, 2006 and December 31, 2005, respectively	(188,762)	(83,378)
Total stockholders equity	994,881	851,005
Total liabilities and stockholders equity	$ 2,243,777	$ 1,971,357

See accompanying notes to condensed consolidated financial statements

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MERITAGE HOMES CORPORATION AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

(in thousands, except per share amounts)

	Three Months Ended September 30, 2006	2005	Nine Months Ended September 30, 2006	2005
Home closing revenue	$ 875,743	$ 753,505	$ 2,624,968	$ 1,956,235
Land closing revenue	2,453	1,945	15,159	3,954
Total closing revenue	878,196	755,450	2,640,127	1,960,189
Cost of home closings	(697,956)	(575,494)	(2,013,651)	(1,506,196)
Cost of land closings	(2,232)	(1,888)	(13,809)	(3,426)
Total cost of closings	(700,188)	(577,382)	(2,027,460)	(1,509,622)
Home closing gross profit	177,787	178,011	611,317	450,039
Land closing gross profit	221	57	1,350	528
Total closing gross profit	178,008	178,068	612,667	450,567
Commissions and other sales costs	(55,934)	(39,635)	(156,810)	(106,975)
General and administrative expenses	(34,347)	(31,894)	(128,413)	(82,529)
Earnings from unconsolidated entities, net	4,238	3,594	15,077	10,108
Other income, net	2,482	2,369	7,867	6,325
Loss on extinguishment of debt				(31,477)
Earnings before provision for income taxes	94,447	112,502	350,388	246,019
Provision for income taxes	(34,908)	(42,249)	(134,058)	(92,331)
Net earnings	$ 59,539	$ 70,253	$ 216,330	$ 153,688
Earnings per common share:				
Basic	$ 2.28	$ 2.57	$ 8.15	$ 5.72
Diluted	$ 2.25	$ 2.40	$ 7.94	$ 5.35
Weighted average number of shares:				
Basic	26,087	27,311	26,554	26,880
Diluted	26,490	29,217	27,259	28,748

See accompanying notes to condensed consolidated financial statements

MERITAGE HOMES CORPORATION AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Nine Months Ended September 30, 2006	2005
Cash flows from operating activities:		
Net earnings	$ 216,330	$ 153,688
Adjustments to reconcile net earnings to net cash used in operating activities:		
Depreciation and amortization	15,272	12,752
Write-off of senior note issuance cost		4,977
Write-off of deposits and land acquisition costs	16,233	
Increase in deferred tax liability		1,385
Stock-based compensation	9,397	
Excess tax benefit from stock-based compensation	(11,190)	
Tax benefit from stock option exercises		9,811
Equity in earnings from unconsolidated entities	(15,077)	(10,108)
Distributions of earnings from unconsolidated entities	13,958	10,008
Changes in assets and liabilities, net of effect of acquisitions:		
Increase in real estate	(192,132)	(372,474)
Increase in deposits on real estate under option or contract	(35,410)	(41,510)
(Increase) decrease in receivables and prepaid expenses and other assets	(26,844)	1,561
(Decrease) increase in accounts payable and accrued liabilities	(39,158)	127,793
(Decrease) increase in home sale deposits	(19,018)	25,539
Net cash used in operating activities	(67,639)	(76,578)
Cash flows from investing activities:		
Investments in unconsolidated entities	(43,057)	(48,081)
Distributions of capital from unconsolidated entities	15,563	12,496
Cash paid for acquisitions		(152,425)
Purchases of property and equipment	(21,328)	(15,480)
Proceeds from sales of property and equipment	1,006	488
Net cash used in investing activities	(47,816)	(203,002)
Cash flows from financing activities:		
Net borrowings under line of credit agreement	206,400	150,800
Proceeds from loans payable and other borrowings, net	1,214	
Repayments of loans payable and other borrowings, net		(13,123)
Proceeds from issuance of senior notes, net		343,836
Payments of senior notes	(1,254)	(285,472)
Purchases of treasury stock	(105,384)	
Proceeds from sale of common stock, net		69,699
Excess tax benefit from stock-based compensation	11,190	
Proceeds from stock option exercises	12,913	6,149
Net cash provided by financing activities	125,079	271,889
Net increase (decrease) in cash and cash equivalents	9,624	(7,691)
Cash and cash equivalents at beginning of period	65,812	47,876
Cash and cash equivalents at end of period	$ 75,436	$ 40,185

See supplemental disclosures of cash flow information at Note 11.

See accompanying notes to condensed consolidated financial statements

NOTE 1 - ORGANIZATION AND BASIS OF PRESENTATION

Organization. We are a leading designer and builder of single-family homes in the growth regions of the southern and western United States, based on the number of home closings. We offer a variety of homes that are designed to appeal to a wide range of homebuyers, including first-time, move-up, luxury and active adult buyers. We have operations in three regions: West, Central and East, which are comprised of 14 metropolitan areas in Arizona, Texas, California, Nevada, Colorado and Florida. Meritage Homes Corporation was incorporated in 1988 as a real estate investment trust in the State of Maryland. In 1996 and 1997, through a merger and acquisition, we acquired the homebuilding operations of our predecessor companies having operations in Arizona and Texas. We currently focus exclusively on homebuilding and related activities and no longer operate as a real estate investment trust. At September 30, 2006, we were actively selling homes in 213 communities, with base prices ranging from $107,000 to $1,176,000.

Basis of Presentation. The accompanying consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles and include the accounts of Meritage Homes Corporation and those of our consolidated subsidiaries, partnerships and other entities in which we have a controlling financial interest, and of variable interest entities (see Note 3) in which we are deemed the primary beneficiary (collectively, the Company). In management s opinion, the data reflects all adjustments, consisting of only normal recurring adjustments, necessary to fairly present our financial position and results of operations for the periods presented. Intercompany balances and transactions have been eliminated in consolidation. These financial statements should be read in conjunction with our audited consolidated financial statements included in our Annual Report on Form 10-K/A for the year ended December 31, 2005.

Common Stock Repurchase. In August 2004, the Board of Directors approved a stock repurchase program authorizing the expenditure of up to $50 million to repurchase shares of our common stock. This program was completed in February 2006, with the repurchase of 601,000 shares at an average price of $59.21.

In February 2006, the Board of Directors approved a new 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 repurchase program. There is no stated expiration date for this program but we will purchase shares subject to applicable securities law and at times and in amounts as management deems appropriate. In the first quarter of 2006, we repurchased 255,000 shares at an average price of $53.77 under this program. In the second quarter of 2006, we repurchased 1,000,000 shares from John R. Landon, our former Co-CEO and Co-Chairman, for $52.19 a share (see Note 13 - Other Events). In August 2006, we repurchased 100,000 shares at an average price of $38.96 per share. At September 30, 2006, we had approximately $130.2 million available under this program to repurchase additional shares.

Off-Balance Sheet Arrangements. We often acquire finished building lots from various development entities pursuant to option and purchase agreements. The purchase price typically approximates the market price at the date the contract is executed. We believe this lot acquisition strategy reduces the financial requirements and risks associated with direct land ownership and land development. Under these option and purchase agreements, we are usually required to make deposits in the form of cash or letters of credit, which may be forfeited if we fail to perform under the applicable agreements. As of September 30, 2006, we had entered into option and purchase agreements with an aggregate purchase price of approximately $2.8 billion and had made deposits of approximately $194.6 million in the form of cash and approximately $68.2 million in letters of credit.

We participate in homebuilding and land development joint ventures from time to time 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. Our participation in joint ventures is an increasingly important part of our business model and we expect it to continue to increase in the future. We and/or our joint venture partners occasionally provide limited repayment guarantees on a pro rata basis on debt of certain unconsolidated land acquisition and development joint ventures. At September 30, 2006, our share of these limited pro rata repayment guarantees was $43.6 million.

In addition, we and/or our joint venture partners occasionally provide guarantees that are only applicable if and when the joint venture directly, or indirectly through agreement with its joint venture partners or other third parties, causes the joint venture to voluntarily file a bankruptcy or similar liquidation or reorganization action or take other actions that are fraudulent or improper (commonly referred to as bad boy guarantees).

These types of guarantees typically are on a pro rata

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basis and are designed to protect the respective secured lender s remedies with respect to its mortgage or other secured lien on the joint venture s underlying property. To date, no such guarantees have been invoked and we believe it is unlikely that such a guarantee would be invoked in the future as it would require us to voluntarily take actions that would generally be disadvantageous to the joint venture and to us. At September 30, 2006, we had outstanding guarantees of this type totaling approximately $80.5 million. We believe that these guarantees, as defined, unless invoked as described above, are not considered guarantees or indebtedness under our revolving credit facility or senior note indentures.

We and our joint venture partners are also typically obligated to the project lenders to complete land development improvements if the joint venture does not perform the required development. Provided we and the other joint venture partners are in compliance with these completion obligations, the project lenders are generally obligated to fund these improvements through any financing commitments available under the applicable joint venture development and construction loans. In addition, we and our joint venture partners have from time to time provided unsecured environmental indemnities to joint venture project lenders. In some instances, our exposure under these indemnities is limited. These indemnities generally obligate us to reimburse the project lenders only for claims related to environmental matters for which such lenders are held responsible. As part of our project acquisition due diligence process to determine potential environmental risks, we generally obtain, or the joint venture entity generally obtains, an independent environmental review from outside consultants.

Additionally, 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. If a joint venture does not perform its obligations, the surety bond could be called. If these surety bonds are called and the joint venture fails to reimburse the surety, we and our joint venture partners would be obligated to indemnify the surety. These surety indemnity arrangements are generally joint and several obligations with our other joint venture partners. As of September 30, 2006, we had approximately $40.1 million of surety bonds outstanding subject to these indemnity arrangements. None of these bonds have been called to date and we believe it is unlikely that any of these bonds will be called.

We also obtain letters of credit and performance, maintenance and other bonds in support of our related obligations with respect to the development of our projects. The amount of these obligations outstanding at any time varies depending on the stage and level of our development activities. In the event the letters of credit or bonds are drawn upon, we would be obligated to reimburse the issuer of the letter of credit or bond. At September 30, 2006, we had approximately $36.9 million in outstanding letters of credit and $269.6 million in performance bonds for such purposes. We believe it is unlikely that any of these letters of credit or bonds will be drawn upon.

Intangibles, Net. Intangible assets consist primarily of non-compete agreements, tradenames and home plan designs acquired in connection with our February 2005 acquisition of Colonial Homes and our September 2005 acquisition of Greater Homes. These intangible assets were valued at the acquisition dates utilizing accepted valuation procedures. The non-compete agreements, tradenames and home plan designs are being amortized over their estimated useful lives. The cost and accumulated amortization of our intangible assets was $11.5 million and $4.0 million, respectively, at September 30, 2006. In the first nine months of 2006, amortization expense was $2.2 million. Amortization expense is expected to be approximately $0.7 million in the remaining three months of 2006 and $2.8, $2.3, $1.2 and $0.5 million per year in 2007, 2008, 2009 and 2010, respectively.

Additionally, in accordance with Statement of Position 98-1, Accounting for Costs of Computer Software Developed or Obtained for Internal Use, we have capitalized software costs at September 30, 2006 of $5.6 million, which is net of accumulated amortization of $4.6 million. In the first nine months of 2006, amortization expense was approximately $2.1 million related to the capitalized software costs and is expected to be approximately $0.8 million for the remaining three months of 2006 and $1.9, $0.8, $0.8, $0.8 and $0.5 million in 2007, 2008, 2009, 2010 and 2011, respectively.

Accrued Liabilities. Accrued liabilities consists of the following (in thousands):

	At September 30, 2006	At December 31, 2005
Accruals related to real estate development and construction activities	$ 140,381	$ 135,953
Payroll and other benefits	56,517	51,382
Accrued taxes	-	48,941
Warranty reserves	27,141	25,168
Other accruals	41,203	28,831
Total	$ 265,242	$ 290,275

Warranty Reserves. As is customary in the homebuilding industry, we have obligations related to post-construction warranties and defect claims for homes closed. We have established reserves for these obligations based on historical data and trends with respect to similar product types and geographic areas. Warranty reserves are included in accrued liabilities on the accompanying condensed consolidated balance sheets. Additions to warranty reserves are included in cost of sales within the accompanying condensed consolidated statements of earnings. We periodically review the adequacy of our warranty reserves, and believe they are sufficient to cover potential costs for materials and labor related to post-construction warranties and defects. A summary of changes in our warranty reserves follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Balance, beginning of period	$ 26,494	$ 17,218	$ 25,168	$ 14,967
Additions to reserve	6,075	5,420	16,468	12,622
Warranty claims and expenses	(5,428)	(2,912)	(14,495)	(7,863)
Balance, end of period	$ 27,141	$ 19,726	$ 27,141	$ 19,726

Recently Issued Accounting Pronouncements. In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R)* (SFAS No. 158). This pronouncement requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability on its statement of financial position. SFAS No. 158 also requires an employer to recognize changes in that funded status in the year in which the changes occur through comprehensive income. In addition, this statement requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. SFAS No. 158 is effective for fiscal years ending after December 15, 2006. The adoption of SFAS No. 158 is not expected to have an impact on our financial position, results of operations or cash flows.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108 (SAB No. 108). Due to diversity in practice among registrants, SAB No. 108 expresses SEC staff views regarding the process by which misstatements in financial statements are evaluated for purposes of determining whether financial statement restatement is necessary. SAB No. 108 is effective for fiscal years ending after November 15, 2006. The adoption of SAB No. 108 is not expected to have a material impact on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS No. 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We are currently reviewing the effect of SFAS No. 157, if any, on our consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of SFAS No. 109 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. Earlier application of the provisions of FIN 48 is encouraged if the enterprise has not yet issued financial statements, including interim financial statements, in the period this interpretation is adopted. We are currently evaluating the impact of the adoption of FIN 48 on our results of operations and statement of financial position.

Reference is made to Note 9 regarding our adoption of SFAS No. 123R, *Share-based Payment.*

NOTE 2 REAL ESTATE AND CAPITALIZED INTEREST

Real estate consists of the following (in thousands):

	At September 30, 2006	At December 31, 2005
Homes under contract under construction	$ 745,742	$ 815,925
Finished home sites and home sites under development	523,940	370,921
Unsold homes, completed and under construction	237,975	116,088
Model homes	30,280	45,060
Model home lease program	28,740	39,336
Land held for development	5,280	3,473
Real estate not owned	5,212	1,464
	$ 1,577,169	$ 1,392,267

Subject to sufficient qualifying assets, we capitalize all development period interest costs incurred in connection with the development and construction of real estate. Capitalized interest is allocated to real estate when incurred and charged to cost of home closings when the related property is delivered. Certain information regarding capitalized interest follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Capitalized interest, beginning of period	$ 27,835	$ 22,029	$ 23,939	$ 19,701
Interest incurred and capitalized	13,874	10,358	38,049	30,197
Amortization to cost of home closings	(12,508)	(9,514)	(32,787)	(27,025)
Capitalized interest, end of period	$ 29,201	$ 22,873	$ 29,201	$ 22,873

NOTE 3 - VARIABLE INTEREST ENTITIES AND CONSOLIDATED REAL ESTATE NOT OWNED

FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (FIN 46R) requires the consolidation of entities in which an enterprise absorbs a majority of the entity s expected losses, receives a majority of the entity s expected residual returns, or both, as a result of ownership, contractual or other financial interests in the entity. Prior to the issuance of FIN 46R, entities were generally consolidated by an enterprise when it had a controlling financial interest through ownership of a majority voting interest in the entity.

Under FIN 46R, a variable interest entity, or VIE, is created when (i) the equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, (ii) equity holders (a) lack direct or indirect ability to make decisions about the entity, (b) are not obligated to absorb expected losses of the entity, or (c) do not have the right to receive expected residual returns of the entity or (iii) the equity investors as a group are considered to lack the direct or indirect ability to make decisions about the entity if (x) the voting rights of some investors are not proportional to their obligations to absorb the expected losses of the entity, their rights to receive the expected residual returns of the entity, or both, and (y) substantially all of the entity s activities either involve or are conducted on behalf of an investor that has disproportionately fewer voting rights.

Based on the provisions of FIN 46R, we have concluded that when we enter into an option or purchase agreement to acquire land or lots from an entity and pay a non-refundable deposit, a VIE is created because we are deemed to have provided subordinated financial support, which refers to variable interests that will absorb some or all of an entity s expected losses if they occur. For each VIE created, we compute expected losses and residual returns based on the probability of future cash flows as outlined in FIN 46R. If we are deemed to be the primary beneficiary of the VIE, because we are obligated to absorb the majority of the expected losses, receive the majority of the residual returns, or both, we will consolidate the VIE in our consolidated financial statements. Not all of our purchase and option agreements are determined to be VIEs.

We have applied FIN 46R by developing a methodology to determine whether or not we are the primary beneficiary of the VIE. Part of this methodology requires the use of estimates in assigning probabilities to various future cash flow possibilities relative to changes in the fair value and changes in the development costs associated with the property. Although we believe that our accounting policy properly identifies our primary beneficiary status with these VIEs, changes in the probability estimates could produce different conclusions regarding our primary beneficiary status.

We generally do not have any ownership interest in the VIEs that hold the lots and land under option or contract, and accordingly, we generally do not have legal or other access to the VIE s books or records. Therefore, it is not possible for us to compel the VIEs to provide financial or other data to us in performing our primary beneficiary evaluation. Accordingly, this lack of information from the VIEs may result in our evaluation being conducted primarily based on management s judgments and estimates.

In most cases, creditors of the entities with which we have option agreements have no recourse against us and the maximum exposure to loss in our option agreements is limited to our option deposit. Often, we are at risk for items over budget related to land development on property we have under option. In these cases, we have contracted to complete development at a fixed cost on behalf of the land owner. Some of our option deposits may be refundable if certain contractual conditions are not performed by the party selling the lots to us. At September 30, 2006, we had no specific performance options, as none of our option agreements require us to purchase lots.

The table below presents a summary of our lots under option or contract at September 30, 2006 (dollars in thousands):

				Option/Earnest Money Deposits	
	Number of Lots	**Fair Value**	**Purchase Price**	**Cash**	**Letters of Credit**
Options recorded on balance sheet as real estate not owned (Note 2) (1), (3)	210	$ 5,212	$ 5,270	$ 832	$
Option contracts not recorded on balance sheet non-refundable deposits (1)	34,996	n/a	$ 2,142,256	$ 157,264	$ 67,701
Purchase contracts not recorded on balance sheet non-refundable deposits (1)	10,070	n/a	405,570	35,574	484
Purchase contracts not recorded on balance sheet refundable deposits (2)	5,501	n/a	236,694	1,806	
Total options not recorded on balance sheet	50,567	n/a	2,784,520	194,644	68,185
Total lots under option	50,777	$ 5,212	$ 2,789,790	$ 195,476	$ 68,185

Notes: Our option to purchase lots remains effective so long as we purchase a pre-established minimum number of lots each month or quarter, as determined by the agreement. The pre-established number typically is structured to approximate our expected rate of home orders.

(1) Deposits are non-refundable except if certain contractual conditions are not performed by the selling party.

(2) Deposits are refundable at our sole discretion. Includes 5,305 lots under control for which we have not completed our acquisition evaluation process and we have not internally committed to purchase.

(3) The purpose and nature of these consolidated lot option contracts (VIEs) is to provide the Company the option to purchase these lots in anticipation of building homes on these lots in the future.

NOTE 4 - INVESTMENTS IN UNCONSOLIDATED ENTITIES

We participate in homebuilding and land development joint ventures from time to time 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. Based on the structure of these joint ventures, they may or may not be consolidated into our results. Our joint venture partners generally are other homebuilders, land sellers or other real estate investors. We also enter into mortgage and title business joint ventures from time to time. These unconsolidated entities follow accounting principles generally accepted in the United States of America and we generally share in their profits and losses in accordance with our ownership interests.

For land development joint ventures, we, and in some cases our joint venture partners, usually receive an option or other similar arrangement to purchase portions of the land held by the joint venture. Option prices are generally negotiated prices that approximate market value when we enter into the option contract. For homebuilding and land development joint ventures, our share of the joint venture earnings relating to lots we purchase from the joint ventures is deferred until homes are delivered by us and title passes to a homebuyer. At such time, we allocate our joint venture earnings to the land acquired by us as a reduction in the basis of the property.

We and/or our joint venture partners occasionally provide limited repayment guarantees on a pro rata basis on the debt of certain unconsolidated land acquisition and development joint ventures. At September 30, 2006, our share of these limited pro rata repayment guarantees was approximately $43.6 million.

In addition, we and/or our joint venture partners occasionally provide guarantees that are only applicable if and when the joint venture directly, or indirectly through agreement with its joint venture partners or other third parties, causes the joint venture to voluntarily file a bankruptcy or similar liquidation or reorganization action or take other actions that are fraudulent or improper (commonly referred to as bad boy guarantees). These types of guarantees typically are on a pro rata basis and are designed to protect the respective secured lender s remedies with respect to its mortgage or other secured lien on the joint venture s underlying property. To date, no such guarantees have been invoked and we believe it is unlikely that such a guarantee would be invoked in the future as it would require us to voluntarily take actions that would generally be disadvantageous to the joint venture and to us. At September 30, 2006, we had outstanding guarantees of this type totaling approximately $80.5 million. By definition, these guarantees, unless invoked as described above, are not considered guarantees or indebtedness under our revolving credit facility or senior note indentures.

Summarized condensed financial information related to unconsolidated joint ventures that are accounted for using the equity method follows (in thousands):

	At September 30, 2006	At December 31, 2005
Assets:		
Cash	$ 37,487	$ 10,337
Real estate	696,979	524,775
Other assets	25,648	22,373
Total assets	$ 760,114	$ 557,485
Liabilities and equity:		
Accounts payable and other liabilities	$ 23,708	$ 32,244
Notes and mortgages payable	480,110	299,498
Equity of:		
Meritage	93,222	72,362
Others	163,074	153,381
Total liabilities and equity	$ 760,114	$ 557,485

	Three Months Ended September 30, 2006	2005	Nine Months Ended September 30, 2006	2005
Revenues	$ 26,933	$ 17,757	$ 72,865	$ 101,292
Costs and expenses	(13,923)	(8,697)	(31,588)	(68,073)
Net earnings of unconsolidated entities	$ 13,010	$ 9,060	41,277	33,219
Meritage s share of pre-tax earnings (1)	$ 4,353	$ 3,594	$ 15,883	$ 11,192

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(1) Our share of pre-tax earnings is recorded in Earnings from unconsolidated entities, net on our consolidated statements of earnings. Our share of pre-tax earnings excludes joint venture earnings related to lots we purchased from the joint ventures. Those earnings are deferred until homes are delivered by us and title passes to a homebuyer.

At September 30, 2006 and December 31, 2005, our investments in unconsolidated entities includes $2.0 million and $1.5 million, respectively, related to the difference between the amounts at which our investments are carried and the amount of underlying equity in net assets. These amounts are amortized to equity of earnings of unconsolidated entities in a manner consistent with the activities of the joint venture, which offsets their related earnings. We amortized approximately $0.1 million to our equity of the joint venture earnings in the third quarter of 2006 and approximately $0.8 million and $1.1 million in the first nine months of 2006 and 2005, respectively. We had no such amortization in the third quarter of 2005.

In addition to joint ventures accounted for under the equity method summarized in the above table, at September 30, 2006, and December 31, 2005, our investments in unconsolidated entities included joint ventures recorded under the cost method. These joint ventures were formed to acquire large parcels of land, to perform off-site development work and to sell lots to the joint venture members and other third parties. As of September 30, 2006, and December 31, 2005, our investments in unconsolidated entities recorded under the cost method were $17.0 and $14.9 million, respectively. As of September 30, 2006, we have not recorded any income or distributions from these joint ventures.

As of September 30, 2006, our total investment in unconsolidated joint ventures of $108.1 million was primarily comprised of $36.1 million in our West Region, $67.5 million in our Central Region and $3.1 million in our East Region. As of December 31, 2005, our total investment in unconsolidated joint ventures of $88.7 million was primarily comprised of $28.5 million in our West Region and $59.4 million in our Central Region.

NOTE 5 - LOANS PAYABLE AND OTHER BORROWINGS

Loans payable consists of the following (in thousands):

	September 30, 2006	December 31, 2005
$850 million unsecured revolving credit facility maturing May 2010 with extension provisions, and interest payable monthly at LIBOR (5.32% at September 30, 2006) plus 1.25% or Prime (8.25% at September 30, 2006)	$ 279,000	$ 72,600
Model home lease program, with interest in the form of lease payments payable monthly approximating 7.83% at September 30, 2006	28,740	39,336
Other borrowings, acquisition and development financing	1,676	462
Total loans payable and other borrowings	$ 309,416	$ 112,398

We have determined that the construction costs and related debt associated with certain model homes that are owned and leased to us by others and that we use to market our communities are required to be included on our balance sheet. We do not legally own these model homes, but we are reimbursed by the owner for our construction costs and we have the right, but not the obligation, to purchase these homes. Although we have no legal obligation to repay any amounts received from the third-party owner, such amounts are recorded as debt and are typically deemed repaid when we simultaneously exercise our option to purchase the model home and sell it to a third-party home buyer. Should we elect not to exercise our rights to

purchase these model homes, the model home costs and related debt under the model lease program will be eliminated upon the termination of the lease, which generally has a maturity date of one to three years.

On May 16, 2006, we amended and restated our senior unsecured revolving credit facility. Under the First Amended and Restated Credit Agreement with Guaranty Bank, as administrative agent, and a number of other financial institutions (the New Credit Agreement), our credit facility was increased from $600 million to $800 million, and the term was extended from May 2009 to May 2010. The maximum borrowings under the New Credit Agreement are based on the amount of qualifying borrowing base assets (generally real estate assets), limited to the facility size. In addition, the New Credit Agreement includes an accordion feature that will allow the Company to request from time to time an increase of up to $250 million in the maximum borrowing commitment. Each member of the lending group may elect to participate or not participate in any request we make to increase the maximum borrowing commitment. In addition, any increase in the borrowing capacity pursuant to this accordion feature is subject to certain terms and conditions, including the absence of an event of default. On June 30, 2006, we exercised a portion of the accordion feature under the New Credit Agreement to increase our borrowing capacity by $50 million to $850 million and amended the New Credit Agreement to make certain other minor changes.

NOTE 6 - SENIOR NOTES

Senior notes consist of the following (in thousands):

	September 30, 2006	December 31, 2005
6.25% senior notes due 2015. At September 30, 2006, and December 31, 2005, there was approximately $1.5 and $1.6 million, respectively, in unamortized discount	$ 348,527	$ 348,396
7.0% senior notes due 2014. At both September 30, 2006, and December 31, 2005, there was approximately $0.1 million in unamortized premium	130,067	130,074
9.75% senior notes due 2011		1,256
	$ 478,594	$ 479,726

In March 2005, we used a portion of the proceeds from the $350 million sale of our 6.25% senior notes to repurchase pursuant to a tender offer and consent solicitation approximately $276.8 million of our outstanding 9.75% senior notes due 2011. In connection with this tender offer and repurchase, we reported a one-time pre-tax charge of approximately $31.5 million for premiums, commissions and expenses associated with the tender offer and the write-off of existing offering costs associated with the 9.75% senior notes, net of the accretion of existing note premiums on the 9.75% senior notes. Later during 2005, we repurchased an additional $2 million of our 9.75% senior notes. During the second quarter of 2006, we repurchased the remaining $1.2 million of our outstanding 9.75% senior notes.

The New Credit Agreement and indentures for the 7% senior notes due 2014 and the 6.25% senior notes due 2015 contain covenants that require maintenance of certain levels of tangible net worth and compliance with certain minimum financial ratios, place limitations on the payment of dividends and redemptions of equity, and limit the incurrence of additional indebtedness, asset dispositions, mergers, certain investments and creations of liens, among other items. As of and for the quarter ended September 30, 2006, we were in compliance with these covenants. After considering our most restrictive bank covenants, we have additional borrowing availability under the New Credit Agreement of approximately $468 million at September 30, 2006 as determined by borrowing base limitations defined by our agreement with the lending banks. The New Credit Agreement and indentures relating to our senior notes restrict our ability to pay dividends, and at September 30, 2006, our maximum permitted amount available to pay dividends was $340.0 million.

Obligations to pay principal and interest on the New Credit Agreement and senior notes are guaranteed by all of our subsidiaries (collectively, the Guarantor Subsidiaries), each of which is directly or indirectly 100% owned by Meritage Homes Corporation. Such guarantees are full and unconditional, and joint and several. We do not provide separate financial statements of the Guarantor Subsidiaries because Meritage (the parent company) has no independent assets or operations, the guarantees are full and unconditional and joint and several and there are no non-guarantor subsidiaries. There are no significant restrictions on the ability of the Company or any Guarantor Subsidiary to obtain funds from their respective subsidiaries, as applicable, by dividend or loan.

NOTE 7 - ACQUISITIONS AND GOODWILL

Greater Homes Acquisition. In September 2005 we purchased all of the outstanding stock of Greater Homes, Inc. (Greater Homes), a builder of single-family homes in Orlando, Florida. The purchase price was approximately $86.2 million in cash, including the repayment of existing debt of approximately $27.7 million. The results of Greater Homes operations have been included in our financial statements since September 1, 2005, the effective date of the acquisition. Assets and liabilities were recorded at their estimated fair market value at the date of acquisition, and are subject to change when we finalize our analysis.

Colonial Homes Acquisition. In February 2005 we purchased the homebuilding and related assets of Colonial Homes of Florida (Colonial Homes), which operates primarily in the Ft. Myers/Naples area. The purchase price was approximately $66.2 million in cash. The results of Colonial Homes operations have been included in our consolidated financial statements as of the effective date of acquisition, February 1, 2005.

Goodwill. Goodwill represents the excess of the purchase price of our acquisitions over the fair value of the assets acquired. The acquisitions of Colonial Homes and Greater Homes were recorded using the purchase method of accounting. The purchase price for each was allocated based on estimated fair values of the assets acquired and liabilities assumed at the date of the acquisition. The excess purchase price over the fair value of the net assets acquired of $27.9 and $10.1 million for Colonial Homes and Greater Homes, respectively, was recorded as goodwill.

The changes in the carrying amount of goodwill for the nine months ended September 30, 2006, follow (in thousands):

	Corporate	West	Central	East	Total
Balance at December 31, 2005	$ 1,323	$ 37,395	$ 54,043	$ 37,461	$ 130,222
Tax benefit of amortization of excess tax basis		(55)	(88)	(279)	(422)
Balance at September 30, 2006	$ 1,323	$ 37,340	$ 53,955	$ 37,182	$ 129,800

Under the guidelines contained in SFAS No. 142, *Goodwill and Other Intangible Assets*, in the first quarter of 2006 management performed its annual assessment of goodwill and determined that no impairment existed.

See Note 11 for a summary of the allocation of the purchase price to acquired assets and liabilities.

NOTE 8 - EARNINGS PER SHARE

Basic and diluted earnings per common share are presented in conformity with SFAS No. 128, Earnings Per Share. The following table presents the calculation of basic and diluted earnings per common share (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Basic weighted average number of shares outstanding	26,087	27,311	26,554	26,880
Effect of dilutive securities:				
Stock options and restricted stock	403	1,906	705	1,868
Diluted weighted average shares outstanding				
Underwriting income (in thousands)				
Casualty	$ 18,617	$ 8,886		
Property	3,949	5,078		
Surety	3,031	1,946		
Total	$ 25,597	$ 15,910		

Combined ratio		
Casualty	78.8	89.8
Property	88.6	80.2
Surety	80.3	86.5
Total	81.4	87.5

Casualty

Gross premiums written for the casualty segment totaled $111.4 million for the first three months of 2007, a decrease of $3.8 million, or 3%, from the same period last year. This decrease is primarily attributable to continuing rate softening in the casualty segment. Despite this softening, margins remain good and we continue to find profitable opportunities. Gross premiums written for specialty program business advanced to $7.2 million for the first quarter of 2007, an increase of $0.5 million, or 8%, over the same period in 2006. Personal umbrella was $14.1 million for the first quarter of 2007, up $0.6 million, or 4%, from the same period in 2006. Despite slight erosion in rates,

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general liability, our largest growth contributor over the past several years, posted gross writings of $47.1 million, a decrease of only $2.5 million, or 5%, from the same period last year, and continued to produce profitable results. Executive products totaled $10.6 million, a decrease of $2.1 million, or 16%, from the first quarter of 2006, due to continuing price declines. As the casualty market continues to soften, we will remain focused on growing areas that provide the best return, while maintaining strict adherence to underwriting discipline.

In total, the casualty segment posted underwriting income of $18.6 million, compared to $8.9 million for the same period last year. Both periods included favorable development on prior years loss reserves. Results for 2007 include favorable experience on prior accident years (1999 through 2004) for general liability, executive products, employer s indemnity, and commercial umbrella. Due to this positive emergence, during the first quarter of 2007, we released reserves. These reserve releases improved the segment s underwriting results by $13.6 million. From a comparative standpoint, results for 2006 included $2.5 million of favorable experience on prior accident years (1996-2003), primarily from executive products. Overall, the combined ratio for the casualty segment was 78.8 for 2007 compared to 89.8 in 2006. The segment s loss ratio was 48.6 in 2007 compared to 61.5 in 2006, primarily driven by the reduction in prior accident years reserve releases. The expense ratio for the casualty segment was 30.2 for the first quarter of 2007 compared to 28.3 for the first quarter of 2006. The increase is primarily attributed to an increase in policy acquisition costs, which include, among other things, performance-related expenses such as bonus and profit sharing-related expenses.

Property

Gross premiums written for the Group s property segment totaled $42.2 million, a decrease of $0.7 million, or 2%, from the same period last year. Our domestic fire book posted $16.9 million in written premiums, a decline of $6.2 million, or 27%, from the first quarter of 2006, as increased competition for non-catastrophe exposed accounts, combined with the softening of rates for coastal wind-exposed risks, have impacted the overall market. Offsetting this decline, our marine division reported $8.8 million in written premium during the first three months of 2007, an increase of $4.6 million, or 110%, from the same period last year.

For the segment, net premiums earned advanced at a faster pace than net premiums written. Net premiums earned for the segment totaled $34.6 million, an increase of $9.0 million, or 35%, from the first quarter of 2006 while net premiums written totaled $23.1 million, a decrease of $1.6 million, or 6%, from the same period in 2006. The increase in net premiums earned is reflective of the earning during 2007 of the significant increase in property premium written during the first three quarters of 2006.

Underwriting income for the segment was $3.9 million for the first three months of 2007, compared to $5.1 million for the same period in 2006. Increased frequency and severity of habitational fire losses have negatively impacted results for 2007. We have revised underwriting guidelines on habitational business and expect to see improvement in this area. We will continue to closely monitor the results of the revised guidelines.

Segment results for 2007 translate into a combined ratio of 88.6, compared to

80.2 for the same period last year. The segment s loss ratio advanced to 50.7 from 37.8 in 2006, due to the aforementioned increased loss activity.

From an expense standpoint, the segment s expense ratio improved to 37.9 from 42.4 in 2006. The expense ratio for the first three months of 2006 was higher due to start-up expenses associated with the new marine division. The net expense ratio is continuing to trend downward as anticipated.

Surety

The surety segment posted gross premiums written of $17.8 million for the first three months of 2007, an increase of $0.7 million, or 4%, from the same period last year. Premium growth was experienced across miscellaneous and energy lines. The segment posted underwriting income of $3.0 million, compared to an income of $1.9 million for the same period last year. The combined ratio for the surety segment totaled 80.3 in 2007, versus 86.5 for the same period in 2006. The segment s loss ratio was 17.8 for 2007, compared to 22.8 for 2006, as favorable loss trends have resulted in a decrease in loss booking ratios. The expense ratio decreased slightly to 62.5 compared to 63.7 for the same period last year.

We are in litigation regarding certain commercial surety bond claims arising out of a specific bond program. A detailed discussion of this litigation can be found in Item 3 Legal Proceedings and note 10 of our 2006 Annual Report on Form 10-K. There have been no significant changes to this litigation since the filing of the Annual Report.

INVESTMENT INCOME AND REALIZED CAPITAL GAINS

During the first three months of 2007, net investment income increased by 13.7% over that reported for the same period in 2006. This improvement was primarily due to an increased asset base. On an after-tax basis, investment income increased by 12.0%. The average annual yields on our investments for the first three months of 2007 and 2006 were as follows.

Pretax Yield	1Q 2007		1Q 2006	
Taxable	5.38	%	5.06	%
Tax-Exempt	4.01	%	3.96	%
After-tax yield				
Taxable	3.50	%	3.29	%
Tax-Exempt	3.80	%	3.75	%

During the first three months of 2007, the yield increased on both the taxable and tax-exempt bonds.

The fixed-income portfolio increased by $18.7 million during the first three months of 2007. This portfolio had a tax-adjusted total return on a mark-to-market basis of 1.6%. Our equity portfolio increased by $6.5 million during the first three months of 2007, to $374.7 million. The equity portfolio had a total return of 1.6% during the first three months of 2007.

We realized a total of $4.6 million in capital gains in the first three months of 2007, compared to capital gains of $4.4 million in the first three months of 2006.

We regularly evaluate the quality of our investment portfolio. When we believe that a specific security has suffered an other-than-temporary decline in value, the investment s value is adjusted by reclassifying the decline from unrealized to realized losses. This has no impact on shareholders equity. During the first three months of 2007 and 2006, there were no losses associated with the other-than-temporary impairment of securities.

The following table is used as part of our impairment analysis and illustrates certain industry-level measurements relative to our equity portfolio as of March 31, 2007, including fair value, cost basis, and unrealized gains and losses.

	3/31/2007 Cost Basis (dollars in thousands)	**Fair Value**	**Gross Unrealized Gains**	**Losses**	**Net**	**Unrealized Gain/Loss% (1)**
Consumer Discretionary	$ 13,372	$ 17,367	$ 4,077	$ (82)	$ 3,995	29.9%
Consumer Staples	16,215	32,310	16,095		16,095	99.3%
Energy	8,965	30,297	21,332		21,332	237.9%
Financials	24,783	61,238	36,531	(76)	36,455	147.1%
Healthcare	14,544	30,937	16,971	(578)	16,393	112.7%
Industrials	15,629	36,703	21,243	(169)	21,074	134.8%
Materials	5,510	8,529	3,019		3,019	54.8%
Information Technology	14,103	21,474	7,582	(211)	7,371	52.3%
Telecommunications	7,015	16,561	9,546		9,546	136.1%
Utilities	44,161	73,411	29,250		29,250	66.2%
Other	45,324	45,841	546	(29)	517	1.1%
	$ 209,621	$ 374,668	$ 166,192	$ (1,145)	$ 165,047	78.7%

(1) Calculated as the percentage of net unrealized gain (loss) to cost basis.

The following table is also used as part of our impairment analysis and illustrates the total value of securities that were in an unrealized loss position as of March 31, 2007. It segregates the securities based on type, noting the fair value, cost (or amortized cost), and unrealized loss on each category of investment as well as in total. The table further classifies the securities based on the length of time they have been in an unrealized loss position.

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Investment Positions with Unrealized Losses

Segmented by Type and Period of Continuous

Unrealized Loss at March 31, 2007

(dollars in thousands)	0-12 Mos.	> 12 Mos.	Total
U.S Government			
Fair value	$ 269	$ 9,627	$ 9,896
Cost or Amortized Cost	276	9,859	10,135
Unrealized Loss	(7)	(232)	(239)
U.S Agency			
Fair value	$ 68,474	$ 167,564	$ 236,038
Cost or Amortized Cost	68,670	168,709	237,379
Unrealized Loss	(196)	(1,145)	(1,341)
Mtge/ABS/CMO*			
Fair value	$ 43,620	$ 121,308	$ 164,928
Cost or Amortized Cost	43,794	123,779	167,573
Unrealized Loss	(174)	(2,471)	(2,645)
Corporate			
Fair value	$ 38,522	$ 91,351	$ 129,873
Cost or Amortized Cost	38,856	94,343	133,199
Unrealized Loss	(334)	(2,992)	(3,326)
States, political subdivisions &revenues			
Fair value	$ 130,542	$ 102,159	$ 232,701
Cost or Amortized Cost	131,151	103,492	234,643
Unrealized Loss	(609)	(1,333)	(1,942)
Subtotal, debt securities			
Fair value	$ 281,427	$ 492,009	$ 773,436
Cost or Amortized Cost	282,747	500,182	782,929
Unrealized Loss	(1,320)	(8,173)	(9,493)
Common Stock			
Fair value	$ 14,864	$	$ 14,864
Cost or Amortized Cost	16,009		16,009
Unrealized Loss	(1,145)		(1,145)
Total			
Fair value	$ 296,291	$ 492,009	$ 788,300
Cost or Amortized Cost	298,756	500,182	798,938
Unrealized Loss	(2,465)	(8,173)	(10,638)

* Mortgage backed, asset backed & collateralized mortgage obligations.

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The following table shows the composition of the fixed income securities in unrealized loss positions at March 31, 2007 by the National Association of Insurance Commissioners (NAIC) rating and the generally equivalent S&P and Moody s ratings. Not all of the securities are rated by S&P and/or Moody s.

NAIC Rating	Equivalent S&P Rating	Equivalent Moody s Rating	(dollars in thousands) Book Value	Fair Value	Unrealized Loss	Percent to Total
1	AAA/AA/A	Aaa/Aa/A	$ 751,915	$ 743,137	$ (8,778)	92.5 %
2	BBB	Baa	31,014	30,299	(715)	7.5 %
3	BB	Ba	0	0	0	
4	B	B	0	0	0	
5	CCC or lower	Caa or lower	0	0	0	
6			0	0	0	
		Total	$ 782,929	$ 773,436	$ (9,493)	100.0 %

The fixed income portfolio contained 404 unrealized loss positions as of March 31, 2007. The $9.5 million in associated unrealized losses for these 404 securities is only 0.7% of the fixed income portfolio s cost basis. Of these 404 securities, 250 have been in an unrealized loss position for more than 12 consecutive months and these collectively represent $8.2 million in unrealized losses (0.6% of total fixed income portfolio s cost basis). None of the fixed income securities were in a loss position of 20% or more and no individual security was in a significant unrealized loss position. All fixed income securities in the investment portfolio continue to pay the expected coupon payments. The fixed income unrealized losses can primarily be attributed to an increase in medium and long-term interest rates since the purchase of many of these fixed income securities. We continually monitor the credit quality of our fixed income investments to gauge our ability to be repaid principal and interest. We consider price declines of securities in our other - than - temporary - impairment analysis where such price declines provide evidence of declining credit quality, and we distinguish between price changes caused by credit deterioration, as opposed to rising interest rates.

Factors that we consider in the evaluation of credit quality include:

1. Credit ratings from major rating agencies, including Moody s and Standard & Poor s,

2. Business and operating performance trends,

3. Management quality/turnover,

4. Industry competitive analysis, and

5. Changes in business model/strategy.

As of March 31, 2007, we held 11 common stock positions that were in unrealized loss positions. Unrealized losses on these securities totaled $1.1 million. All of these securities have been in an unrealized loss position for less than twelve months. Based on our evaluation of equity securities held within specific industry sectors, as well as the duration and magnitude of unrealized losses in our equity and bond portfolios, we do not believe any securities suffered an other - than - temporary decline in value as of March 31, 2007.

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INCOME TAXES

Our effective tax rate for the first three months of 2007 was 31% compared to 29% for the same period in 2006. The effective rate for the first quarter of 2007 is higher due to the increase in underwriting income, which is taxed at 35%. Effective rates are dependent upon components of pretax earnings and the related tax effects.

Income tax expense attributable to income from operations differed from the amounts computed by applying the U.S. federal tax rate of 35% to pretax income for the first three months of 2007 and 2006 as a result of the following:

	2007				**2006**			
(in thousands)	**Amount**		**%**		**Amount**		**%**	
Provision for income taxes at the Statutory rate of 35%	$ 16,499		35	%	$ 12,692		35	%
Increase (reduction) in taxes resulting from:								
Tax exempt interest income	(1,488	)	-3	%	(1,512	)	-4	%
Dividends received deduction	(442	)	-1	%	(458	)	-1	%
Dividends paid deduction	(120	)	0	%	(116	)	-1	%
Other items, net	172		0	%	1		0	%
Total tax expense	$ 14,621		31	%	$ 10,607		29	%

LIQUIDITY AND CAPITAL RESOURCES

We have three primary types of cash flows: (1) cash flows from operating activities, which consist mainly of cash generated by our underwriting operations and income earned on our investment portfolio, (2) cash flows from investing activities related to the purchase, sale and maturity of investments, and (3) cash flows from financing activities that impact our capital structure, such as changes in debt and shares outstanding.

The following table summarizes cash flows for the three month periods ended March 31, 2007 and 2006.

	2007		**2006**	
	(in thousands)			
Operating cash flows	$ 25,310		$ 21,709	
Investing cash flows	$ (2,383	)	$ (5,578	)
Financing cash flows	$ (22,927	)	$ (16,131	)
Total	$		$	

Cash flows from operating activities increased during the first three months of 2007 compared to that reported for the same period in 2006, due to the timing of certain reinsurance, claim, and other payments. In 2007, available operating cash flow has been primarily used in financing activities to fund the repurchase of our stock. In 2006, available operating cash flow was used in investing activities to purchase additional investment securities and to

fund the repurchase of our stock. On February 10, 2006, we announced a stock repurchase program for up to $100.0 million in RLI common stock. During the first quarter of 2007, we repurchased 333,494 shares at an average cost of $56.77 per share. This completed the buyback program at an overall average per share cost of $51.08.

We have $100.0 million in long-term debt outstanding. On December 12, 2003, we completed a public debt offering, issuing $100.0 million in senior notes maturing January 15, 2014 (a 10-year maturity), and paying interest semi-annually at the rate of 5.95% per annum. The notes were issued at a discount resulting in proceeds, net of discount and commission, of $98.9 million.

We are not party to any off-balance sheet arrangements.

At March 31, 2007, we had short-term investments and other investments maturing within one year, of approximately $72.9 million and investments of $372.3 million maturing within five years. We maintain revolving lines of credit with two financial institutions, each of which permits us to borrow up to an aggregate principal amount of $10.0 million. Under certain conditions, each of the lines may be increased up to an aggregate principal amount of $20.0 million. The facilities have three-year terms that expire on May 31, 2008. As of March 31, 2007, no amounts were outstanding on these facilities.

We believe that cash generated by operations, cash generated by investments and cash available from financing activities will provide sufficient sources of liquidity to meet our anticipated needs over the next 12 to 24 months.

We maintain a well-diversified investment portfolio representing policyholder funds that have not yet been paid out as claims, as well as the capital we hold for our shareholders. As of March 31, 2007, our investment portfolio had a book value of $1.8 billion. Invested assets at March 31, 2007, increased by $9.5 million from December 31, 2006.

As of March 31, 2007, our fixed-income portfolio had the following rating distribution:

AAA	**77.9**	**%**
AA	**10.1**	**%**
A	**8.3**	**%**
BBB	**3.7**	**%**
Total	**100.0**	**%**

As of March 31, 2007, the duration of the fixed income portfolio was 4.67 years. Our fixed-income portfolio remained well diversified, with 765 individual issues as of March 31, 2007.

At March 31, 2007, our equity portfolio had a value of $374.7 million and is also a source of liquidity. The securities within the equity portfolio remain primarily invested in large-cap issues with strong dividend performance. Included within our equity portfolio are certain preferred stocks, and real estate investment trust (REIT) securities. The strategy remains one of value investing, with security selection taking precedence over market timing. We use a buy-and-hold strategy, minimizing both transactional costs and taxes.

As of March 31, 2007, our equity portfolio had a dividend yield of 2.6%

compared to 1.8% for the S&P 500 index. Because of the corporate-dividend-received deduction applicable to our dividend income, we pay an effective tax rate of only 14.2% on dividends, compared to 35.0% on taxable interest and REIT income and 5.3% on municipal bond interest income. As with our bond portfolio, we maintain a well-diversified group of 112 equity securities.

Our capital structure is comprised of equity and debt outstanding. As of March 31, 2007, our capital structure consisted of $100.0 million in 10-year maturity senior notes maturing in 2014 (long-term debt), and $766.8 million of shareholders equity. Debt outstanding comprised 11.5% of total capital as of March 31, 2007.

Our 123rd consecutive quarterly dividend payment was declared in the first quarter of 2007 and paid on April 13, 2007 in the amount of $0.20 per share. Since the inception of cash dividends in 1976, we have increased our annual dividend every year. In its annual Handbook of Dividend Achievers, Mergent FIS (formerly a division of Moody s) ranked us 171st of more than 11,000 U.S. public companies in dividend growth over the last decade.

Dividend payments to us from our principal insurance subsidiary are restricted by state insurance laws as to the amount that may be paid without prior approval of the regulatory authority of Illinois. The maximum dividend distribution is limited by Illinois law to the greater of 10% of RLI Insurance Company s policyholder surplus as of December 31 of the preceding year, or its net income for the 12-month period ending December 31 of the preceding year. Therefore, the maximum dividend distribution that can be paid by RLI Insurance Company during 2007 without prior approval is $75.7 million. Dividends paid in the form of asset transfers are applied to the dividend limitation at the estimated fair value of the asset as of the dividend date. In the first three months of 2007, no affiliate dividends were paid from insurance subsidiaries, leaving the full dividend capacity for the remainder of 2007.

Interest and fees on debt obligations totaled $1.5 million for the first three months of 2007, down $0.2 million from the same period in 2006. As of March 31, 2007, outstanding debt balances totaled $100.0 million, compared to $115.3 million at March 31, 2006. The March 31, 2006 balance of $115.3 million consisted of $100.0 million in senior notes and $15.3 in reverse repurchase agreements. We have incurred interest expense on debt at the following average interest rates for the three month periods ended March 31, 2007 and 2006:

	1Q 2007	**1Q 2006**
Line of Credit	NA	NA
Reverse repurchase agreements	NA	4.55 %
Total short-term debt	NA	4.55 %
Senior Notes	6.02 %	6.02 %
Total Debt	6.02 %	5.86 %

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ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk is the risk of economic losses due to adverse changes in the estimated fair value of a financial instrument as the result of changes in equity prices, interest rates, foreign exchange rates and commodity prices. Our consolidated balance sheets include assets and liabilities whose estimated fair values are subject to market risk. The primary market risks are equity price risk associated with investments in equity securities and interest rate risk associated with investments in fixed maturities. From time to time, equity prices and interest rates fluctuate causing an effect on our investment portfolio. We have no exposure to foreign exchange risk and no direct commodity risk.

Our market risk exposures at March 31, 2007, have not materially changed from those identified in our 2006 Annual Report on Form 10-K.

ITEM 4. Controls and Procedures

We maintain a system of controls and procedures designed to provide reasonable assurance as to the reliability of the financial statements and other disclosures included in this report, as well as to safeguard assets from unauthorized use or disposition. An evaluation of the effectiveness of the design and operation of our disclosure controls and procedures was performed, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective, as of the end of the period covered by this report.

In designing and evaluating our disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurances of achieving the desired control objective, and management necessarily is required to apply its judgment in evaluating the cost - benefit relationship of possible controls and procedures. We believe that our disclosure controls and procedures provide such reasonable assurance.

No changes were made to our internal control over financial reporting during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. **Legal Proceedings**

RLI Corp., RLI Insurance Company and Mt. Hawley Insurance Company are defendants in an ongoing lawsuit that is seeking class-action status in federal court in New Jersey, which was brought in October 2004 against over 100 insurance brokers and insurance companies by a putative class of plaintiffs who purchased insurance from the defendants. This lawsuit alleges injury through state and federal antitrust violations, RICO violations, breach of fiduciary duties and unjust enrichment resulting from the payment of contingent commissions by the defendant insurers to the defendant brokers. The complaint seeks unspecified amounts in damages, including punitive damages, as well as other legal and equitable relief. We deny the allegations made and are vigorously contesting this suit.

On April 5, 2007, the court dismissed the case in response to the defendants motion to dismiss, and stayed all ongoing discovery and other action in the case. The court allowed the plaintiffs 30 days to amend the complaint to state a legally valid claim. We cannot predict the final outcome of this action.

Item 1A. **Risk Factors -** There were no material changes to report.

Item 2. **Unregistered Sales of Equity Securities and Use of Proceeds** Not Applicable

Item 3. **Defaults Upon Senior Securities** Not Applicable

Item 4. **Submission of Matters to a Vote of Security Holders** Not Applicable

Item 5. **Other Information -** Not Applicable

Item 6. **Exhibits**

Exhibit 31.1 Certification Pursuant to Section 302 of the Sarbanes Oxley Act of 2002

Exhibit 31.2 Certification Pursuant to Section 302 of the Sarbanes Oxley Act of 2002

Exhibit 32.1 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes Oxley Act of 2002

Exhibit 32.2 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes Oxley Act of 2002

SIGNATURES

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

RLI Corp.

/s/Joseph E. Dondanville
Joseph E. Dondanville
Sr. Vice President, Chief Financial Officer
(Principal Financial and
Chief Accounting Officer)

Date: April 27, 2007