AFFORDABLE RESIDENTIAL COMMUNITIES INC
Form 10-Q
May 14, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2007
OR

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

Commission File Number 1-31987

Affordable Residential Communities Inc.

(Exact name of Registrant as specified in its charter)

MARYLAND	**84-1477939**
(State of incorporation)	(I.R.S. employer identification no.)
7887 East Belleview Avenue, Suite 200 Englewood, Colorado	**80111**
(Address of principal executive offices)	(Zip code)

(303) 291-0222

(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 o Accelerated filer x Non-accelerated filer o

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

The number of shares of the Registrant s common stock outstanding at May 10, 2007 was 56,400,427.

AFFORDABLE RESIDENTIAL COMMUNITIES INC.
FORM 10-Q
FOR THE QUARTER ENDED MARCH 31, 2007

Item	Description	Page
	PART I FINANCIAL INFORMATION	
1.	Consolidated Financial Statements	
	Consolidated Balance Sheets as of March 31, 2007 and December 31, 2006 (unaudited)	2
	Consolidated Statements of Operations for the Three Months ended March 31, 2007 and 2006 (unaudited)	4
	Consolidated Statement of Stockholders Equity for the Three Months ended March 31, 2007 (unaudited)	5
	Consolidated Statements of Cash Flows for the Three Months ended March 31, 2007 and 2006 (unaudited)	6
	Notes to Consolidated Financial Statements (unaudited)	8
2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	36
3.	Quantitative and Qualitative Disclosures About Market Risk	52
4.	Controls and Procedures	53
	PART II OTHER INFORMATION	
6.	Exhibits	54

AFFORDABLE RESIDENTIAL COMMUNITIES INC.
CONSOLIDATED BALANCE SHEETS
AS OF MARCH 31, 2007 AND DECEMBER 31, 2006
(in thousands)
(unaudited)

	March 31, 2007	December 31, 2006
Assets		
Rental and other property, net	$ 1,374,594	$ 1,390,564
Assets held for sale	15,460	15,326
Investments		
Trading securities, at fair value (cost of $625)	619	
Securities available for sale, at fair value (amortized cost of $118,364)	119,744	
Securities held to maturity, at amortized cost (fair value of $6,476)	6,472	
Cash and cash equivalents	62,317	29,281
Restricted cash	6,841	6,784
Tenant and other receivables, net	4,061	4,651
Reinsurance receivables, net of uncollectible amounts	5,633	
Premiums receivable	21,895	
Notes receivable, net	29,114	29,904
Loan origination costs, net	16,230	16,736
Loan reserves	36,615	33,305
Goodwill	24,057	
Indefinite lived intangible assets	3,000	
Finite lived intangible assets	19,426	6,457
Deferred income taxes	24,095	
Deferred acquisition costs	3,084	
Prepaid expenses and other assets	16,588	9,693
Total assets	$ 1,789,845	$ 1,542,701

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

2

AFFORDABLE RESIDENTIAL COMMUNITIES INC.
CONSOLIDATED BALANCE SHEETS (Continued)
AS OF MARCH 31, 2007 AND DECEMBER 31, 2006
(in thousands, except share and per share data)
(unaudited)

	March 31, 2007	December 31, 2006
Liabilities and Stockholders Equity		
Notes payable	$ 1,107,213	$ 1,046,500
Reserve for losses and loss adjustment expenses	22,376	
Unearned premiums	55,740	
Liabilities related to assets held for sale	63	247
Accounts payable and accrued expenses	33,330	28,946
Dividends payable	1,719	1,903
Tenant deposits and other liabilities	18,682	17,727
Total liabilities	1,239,123	1,095,323
Minority interest	10,970	28,142
Commitments and contingencies		
Stockholders equity		
Preferred stock, no par value, 5,750,000 shares authorized, 5,000,000 shares issued and outstanding at March 31, 2007 and December 31, 2006, respectively; liquidation preference of $25 per share plus accrued but unpaid dividends	119,108	119,108
Common stock, $.01 par value, 100,000,000 shares authorized, 56,398,430 and 41,346,287 shares issued and outstanding at March 31, 2007 and December 31, 2006, respectively	564	413
Additional paid-in capital	923,489	794,653
Accumulated other comprehensive income	494	
Retained deficit	(503,903)	(494,938)
Total stockholders equity	539,752	419,236
Total liabilities and stockholders equity	$ 1,789,845	$ 1,542,701

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

AFFORDABLE RESIDENTIAL COMMUNITIES INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE THREE MONTHS ENDED MARCH 31, 2007 AND 2006
(in thousands, except per share data)
(unaudited)

	Three Months Ended March 31, 2007	2006
Revenue		
Rental income	$ 53,642	$ 50,906
Net premiums earned	16,719	
Sales of manufactured homes	2,535	2,672
Utility and other income	7,120	6,477
Fee and other insurance income	1,317	
Net investment income	1,331	
Net realized gains on investments	66	
Net consumer finance interest income	374	179
Total revenue	83,104	60,234
Expenses		
Property operations	17,589	16,422
Real estate taxes	4,837	5,136
Losses and loss adjustment expenses	8,877	
Cost of manufactured homes sold	2,090	2,309
Retail home sales, finance and other	1,864	1,898
Property management	1,847	1,592
General and administrative	5,385	4,421
Underwriting expenses	6,603	
Depreciation and amortization	21,865	21,611
Loss on sale of airplane		541
Interest expense	18,488	19,581
Total expenses	89,445	73,511
Interest income	(494)	(423)
Loss from continuing operations before income tax benefit and allocation to minority interest	(5,847)	(12,854)
Income tax (expense) benefit from continuing operations	(687)	1,199
Loss from continuing operations before allocation to minority interest	(6,534)	(11,655)
Minority interest	271	236
Loss from continuing operations	(6,263)	(11,419)
(Loss) income from discontinued operations	(128)	1,692
Gain on sale of discontinued operations		10,296
Income tax expense from discontinued operations		(4,795)
Minority interest in discontinued operations	4	(253)
Net loss	(6,387)	(4,479)
Preferred stock dividend	(2,578)	(2,578)
Net loss attributable to common stockholders	$ (8,965)	$ (7,057)
Loss per share from continuing operations		
Basic loss per share	$ (0.17)	$ (0.32)
Diluted loss per share	$ (0.17)	$ (0.32)
Income per share from discontinued operations		
Basic income per share	$	$ 0.16
Diluted income per share	$	$ 0.16
Loss per share attributable to common stockholders		
Basic loss per share	$ (0.17)	$ (0.16)
Diluted loss per share	$ (0.17)	$ (0.16)
Weighted average share information		
Basic shares outstanding	52,328	43,576

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

AFFORDABLE RESIDENTIAL COMMUNITIES INC.
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
FOR THE THREE MONTHS ENDED MARCH 31, 2007
(in thousands)
(unaudited)

	Preferred Stock Shares	Amount	Common Stock Shares	Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income	Retained Deficit	Total Stockholders' Equity
Balance January 1, 2007	5,000	$ 119,108	41,346	$ 413	$ 794,653	$	$ (494,938)	$ 419,236
Common stock issued to board members			3		36			36
Rights offering shares			10,000	100	78,349			78,449
Preferred partnership unit redemption			1,628	16	17,626			17,642
Share issuance			3,374	34	33,324			33,358
Stock compensation expense					300			300
Amortization of unearned compensation					14			14
Transfer of minority interest ownership in Operating Partnership					(1,371)			(1,371)
Redemption of OP units for common stock			47	1	558			559
Accumulated other comprehensive income						494 *		494
Net loss							(8,965)	(8,965)
Balance March 31, 2007	5,000	$ 119,108	56,398	$ 564	$ 923,489	$ 494	$ (503,903)	$ 539,752

* Net of tax effect of $264,000.

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

5

AFFORDABLE RESIDENTIAL COMMUNITIES INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED MARCH 31, 2007 and 2006
(in thousands)
(unaudited)

	Three Months Ended March 31, 2007	2006
Cash flow from operating activities		
Net loss	$ (6,387)	$ (4,479)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	21,865	21,611
Intra-period income taxes		3,596
Deferred income taxes	687	
Increase in unearned premiums	6,169	
Increase in deferred acquisition costs	(3,084)	
Realized gains on investments	(66)	
Purchases of trading securities	(191)	
Proceeds from sales of trading securities	162	
Adjustments to fair value for interest rate caps	57	(312)
Amortization of loan origination costs	1,069	1,434
Stock grant compensation expense	350	49
Partnership preferred unit distributions	67	276
Minority interest	(338)	(512)
Depreciation and minority interest included in income from discontinued operations		472
Gain on sale of discontinued operations		(10,296)
Loss on sale of airplane		541
Gain on sale of manufactured homes	(445)	(363)
Changes in operating assets and liabilities	(4,693)	(8,078)
Net cash provided by operating activities	15,222	3,939
Cash flow from investing activities		
NLASCO acquisition	(116,115)	
Cash acquired from NLASCO	45,457	
Purchases of manufactured homes	(3,286)	(1,964)
Proceeds from community sales		60,804
Proceeds from manufactured home sales	2,402	2,561
Proceeds from sale of airplane		1,170
Community improvements and equipment purchases	(1,540)	(1,815)
Restricted cash	(57)	320
Loan reserves	(3,310)	(219)
Purchases of available-for-sale securities	(9,000)	
Purchases of held-to-maturity securities	(413)	
Proceeds from sales of available-for-sale securities	3,172	
Proceeds from maturities of held-to-maturity securities	1,200	
Net cash (used in) provided by investing activities	(81,490)	60,857

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

AFFORDABLE RESIDENTIAL COMMUNITIES INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)
FOR THE THREE MONTHS ENDED MARCH 31, 2007 and 2006
(in thousands)
(unaudited)

	Three Months Ended March 31,	
	2007	**2006**
Cash flow from financing activities		
Cash flow from rights offering and stock issuances		
Common stock rights offering	80,000	
Common stock offering expenses	(1,551)	
Proceeds from issuances of common stock	20,000	
Proceeds from issuance of debt	14,891	23,035
Repayment of debt	(10,644)	(80,918)
Payment of preferred dividends	(2,578)	(2,578)
Payment of partnership preferred distributions	(251)	(276)
Loan origination costs	(563)	(673)
Net cash provided by (used in) financing activities	99,304	(61,410)
Net increase in cash and cash equivalents	33,036	3,386
Cash and cash equivalents, beginning of period	29,281	27,926
Cash and cash equivalents, end of period	$ 62,317	$ 31,312
Non-cash financing and investing transactions:		
Debt and other liabilities assumed in the NLASCO acquisition	$ 136,288	$
Redemption of OP units for common stock	$ 18,201	$ 3,035
Fair value of common stock issued in the NLASCO acquisition	$ 13,359	$
Notes receivable issued for manufactured home sales	$ 839	$ 1,862
Dividends declared but unpaid	$ 1,719	$ 1,903
Supplemental cash flow information:		
Payments on notes receivable included in proceeds from manufactured home sales	$ 1,707	$ 1,766
Cash paid for interest	$ 20,229	$ 21,719

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

7

AFFORDABLE RESIDENTIAL COMMUNITIES INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. Business, Basis of Presentation and Summary of Significant Accounting Policies

Business

Affordable Residential Communities Inc. is a Maryland corporation that is engaged in the acquisition, renovation, repositioning and operation of primarily all-age manufactured home communities, the retail sale and financing of manufactured homes, the rental of manufactured homes and other related businesses, all exclusively to residents in our communities. On January 31, 2007, we acquired all of the stock of NLASCO, Inc. (NLASCO), a privately held property and casualty insurance holding company. NLASCO is a Delaware corporation that specializes in providing fire and homeowners insurance to low value dwellings and manufactured homes primarily in Texas and other areas of the south, southeastern and southwestern United States. NLASCO operates through its wholly-owned subsidiaries, National Lloyds Insurance Company (NLIC) and American Summit Insurance Company (ASIC).

We were organized in July 1998 and operate primarily through Affordable Residential Communities LP (the Operating Partnership or OP) and its subsidiaries, of which we are the sole general partner and owned 97.4% as of March 31, 2007.

As of March 31, 2007, we owned and operated 275 communities consisting of 57,264 homesites in 23 states with occupancy of 82.7%. Our five largest markets are Dallas-Fort Worth, Texas, with 12.5% of our total homesites; Atlanta, Georgia, with 8.7% of our total homesites; Salt Lake City, Utah, with 6.6% of our total homesites; the Front Range of Colorado, with 5.7% of our total homesites; and Kansas City-Lawrence-Topeka, with 4.3% of our total homesites. Our insurance operations are headquartered in Waco, Texas.

Our common stock is traded on the New York Stock Exchange under the symbol ARC . Our Series A Cumulative Redeemable Preferred Stock is traded on the New York Stock Exchange under the symbol ARC-PA . We have no public trading history prior to February 12, 2004.

Basis of Presentation

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America and in conformity with the rules and regulations of the Securities and Exchange Commission requires us to make estimates and assumptions that affect the reported amount of assets and liabilities, the disclosure of contingent assets and liabilities and the reported amount of revenues and expenses during the reporting period. Actual results may differ from previously estimated amounts.

The interim consolidated financial statements presented herein reflect all adjustments that are necessary to fairly present the financial position, results of operations and cash flows of the Company, and all such adjustments are of a normal and recurring nature. The results of operations for the interim period ended March 31, 2007 are not indicative of the results that may be expected for the year ended December 31, 2007. Operating results and cash flows of NLASCO are for the two months from the date of acquisition, January 31, 2007, through March 31, 2007. These financial statements should be read in conjunction with the financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2006.

The accompanying consolidated financial statements include all of our accounts, which include the results of operations of the manufactured home communities acquired only for the periods subsequent to the date of acquisition. We have eliminated all significant inter-company balances and transactions.

We have reclassified certain prior period amounts to conform to the current year presentation.

Summary of Significant Accounting Policies

Rental and Other Property

We carry rental property at cost, less accumulated depreciation. We capitalize significant renovations and improvements that extend the useful life of assets and depreciate them over their estimated remaining useful lives. We expense maintenance and repairs as incurred. Depreciation is computed primarily using the straight-line method over the estimated useful lives of the assets. The estimated useful lives of the various classes of rental property assets are as follows:

Asset Class	Estimated Useful Lives (Years)
Manufactured home communities and improvements	10 to 30
Buildings	10 to 20
Rental homes	10 or rent-to-own term
Furniture and other equipment	5
Computer software and hardware	3

We evaluate the recoverability of our investment in rental property whenever events or changes in circumstances indicate that the recoverability of the net book value of the asset is questionable. Our assessment of the recoverability of rental property includes, but is not limited to, recent operating results and expected net operating cash flows from future operations. In the event that facts and circumstances indicate that the carrying amount of rental property may be impaired, we perform an evaluation of recoverability in which we compare the estimated future undiscounted cash flows associated with the asset to the asset s carrying amount to determine if an impairment adjustment is required. If this review indicates that the asset s carrying amount will not be fully recoverable, we will reduce the carrying value of the asset to its estimated fair value. We recorded no impairment charges during the three months ended March 31, 2007 and 2006.

Investment Securities

Investment securities at March 31, 2007 consist of U.S. Government, mortgage-backed, corporate debt and equity securities. We classify our fixed maturities in one of three categories: trading, available-for-sale or held-to-maturity. Our equity securities are classified as trading or available-for-sale. Trading securities are bought and held principally for the purpose of selling them in the near term. Held-to-maturity debt securities are those securities in which we have the ability and intent to hold the security until maturity. All securities not included in trading or held-to-maturity are classified as available-for-sale.

Trading and available-for-sale securities are recorded at fair value. Held-to-maturity debt securities are recorded at amortized cost, adjusted for the amortization or accretion of premiums or discounts. Unrealized holding gains and losses on trading securities are included in earnings. Unrealized holding gains and losses, net of the related tax effect, on available-for-sale securities are excluded from earnings and are reported as a separate component of other comprehensive income until realized. Realized gains and losses from the sale of trading and available-for-sale securities are determined on a specific-identification basis.

The Company regularly reviews its investment securities to assess whether the amortized cost is impaired and if impairment is other than temporary. A decline in the market value of any available-for-sale or held-to-maturity security below cost that is deemed to be other-than-temporary results in a reduction in carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. To determine whether an impairment is other-than-temporary, the Company considers

whether it has the ability and intent to hold the investment until a market price recovery and considers whether evidence indicating the cost of the investment is recoverable outweighs evidence to the contrary. Evidence considered in this assessment includes the reasons for the impairment, the severity and duration of the impairment, changes in value subsequent to year-end, and forecasted performance of the investee.

Premiums and discounts are amortized or accreted over the life of the related held-to-maturity or available-for-sale security as an adjustment to yield using the effective-interest method. Dividend and interest income are recognized when earned.

Premiums Receivable

Premiums receivable include premiums written and not yet collected. The Company regularly evaluates premiums receivable and establishes valuation allowances as appropriate. At March 31, 2007, the Company determined no valuation allowance was necessary.

Deferred Acquisition Costs

Costs of acquiring insurance that vary with and are primarily related to the production of new and renewal business, primarily consisting of commissions, premium taxes and underwriting expenses, are deferred and amortized over the terms of the policies or reinsurance treaties to which they relate. Proceeds from reinsurance transactions that represent recovery of acquisition costs shall reduce applicable unamortized acquisition costs in such a manner that net acquisition costs are capitalized and charged to expense in proportion to net revenue recognized. Future investment income is considered in determining the recoverability of deferred acquisition costs. The Company regularly reviews the categories of acquisition costs that are deferred and assesses the recoverability of this asset. A premium deficiency and a corresponding charge to income is recognized if the sum of the expected loss and loss adjustment expenses, unamortized acquisition costs, and maintenance costs exceed related unearned premiums and anticipated investment income. At March 31, 2007, there was no premium deficiency.

Goodwill and Other Indefinite Lived Intangible Assets

Goodwill represents the excess of the cost over the fair value of the net assets of NLASCO. Goodwill is tested annually for impairment and is tested more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset s fair value. For goodwill, the impairment determination is made at the reporting unit level and consists of two steps. First, the Company determines the fair value of a reporting unit and compares it to its carrying amount. Second, if the carrying amount of a reporting unit exceeds its fair value, an impairment loss is recognized for any excess of the carrying amount of the reporting unit s goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation, in accordance with FASB Statement No. 141, Business Combinations. The residual fair value after this allocation is the implied fair value of the reporting unit goodwill. In connection with an acquisition made by NLASCO prior to its acquisition by ARC, the Company may make additional contingent acquisition payments of up to $1.5 million based on attainment of certain financial targets. Other indefinite lived intangible assets consist of $3.0 million of estimated fair value of state licenses acquired in the NLASCO purchase.

Finite Lived Intangible Assets

We record finite lived intangible assets at the estimated fair value of the assets acquired and amortize the assets over their estimated useful lives. The following finite lived intangible assets were acquired when the Company purchased NLASCO (in thousands).

	Estimated Fair Value	**Estimated Useful Life**
Customer relationships	$ 6,100	12 years
Agent relationships	3,600	13 years
Trade name	3,500	15 years
Software	1,500	5 years
Total	$ 14,700	
Less accumulated amortization	(331)	
Balance at March 31, 2007	$ 14,369	

Customer and agent relationships are amortized using the double declining balance method to approximate the non-renewal rate of customers and attrition of agents. The trade name and software are amortized using the straight-line method. Also included in finite lived intangible assets are lease intangibles and other customer relationships of $5.1 million related to ARC s manufactured home communities.

Losses and Loss Adjustment Expenses

The liability for losses and loss adjustment expenses includes an amount determined from loss reports and individual cases and an amount, based on past experience, for losses incurred but not reported. Such liabilities are necessarily based on estimates and, while management believes that the amount is adequate, the ultimate liability may be in excess of or less than the amounts provided. The methods for making such estimates and for establishing the resulting liability are continually reviewed, and any adjustments are reflected in earnings currently. The liability for losses and loss adjustment expenses has not been reduced for reinsurance recoverable.

Premium Revenue Recognition

Property and liability premiums are generally recognized as revenue on a pro rata basis over the policy term. The portion of premiums that will be earned in the future are deferred and reported as unearned premiums.

Reinsurance

In the normal course of business, the Company seeks to reduce the loss that may arise from catastrophes or other events that cause unfavorable underwriting results by reinsuring certain levels of risk in various areas of exposure with other insurance enterprises or reinsurers. Amounts recoverable from reinsurers are estimated in a manner consistent with the reinsured policy.

Stock Compensation

During 2004 we granted 95,000 shares of restricted common stock that vest over five years. In June 2004, 42,500 of these restricted shares were forfeited and in October 2004, an additional 37,500 shares of restricted stock were forfeited pursuant to the terms of their issuance, leaving 15,000 restricted shares outstanding. During each of the three month periods ended March 31, 2007, 2006 and 2005, 3,000 shares vested leaving 6,000 shares unvested at March 31, 2007. We have recorded the unvested

portion of the remaining 6,000 outstanding restricted shares as of March 31, 2007 as unearned compensation and are amortizing the balance ratably over the vesting period. We recorded $14,000 in compensation expense related to these restricted shares during both of the three month periods ended March 31, 2007 and 2006. We expect that there will be no forfeitures of the unvested restricted stock outstanding at March 31, 2007.

We consider the number of vested shares issued under our 2003 equity incentive plan as common stock outstanding and include them in the denominator of our calculation of basic earnings per share. We also consider the total number of unvested restricted shares granted under our 2003 equity incentive plan in the denominator of our calculation of diluted earnings per share if they are dilutive. We return shares forfeited to the 2003 equity incentive plan as shares eligible for future grant and adjust any compensation expense previously recorded on such shares in the period the forfeiture occurs.

Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the estimated future tax effects attributable to the temporary difference between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and net operating loss and tax credit carry-forwards. Deferred tax assets are reduced by a valuation allowance to the extent that their benefits are not expected to be realized. At March 31, 2007 and December 31, 2006, valuation allowances of $65.4 million and $84.4 million, respectively, were recorded to reduce deferred tax assets to the amount expected to be recoverable.

We allocate income taxes between continuing and discontinued operations in accordance with Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes* (SFAS No. 109), specifically paragraph 140. We recognize interim income tax benefits in continuing operations on the effective rate method and income tax expense in discontinued operations without such pro-ration in accordance with Accounting Principles Bulletin 28, *Interim Financial Reporting* (APB 28) and FASB Interpretations 18, *Accounting for Income Taxes in Interim Periods An interpretation of APB Opinion No. 28* (FIN 18).

Effective January 1, 2007, we adopted FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in 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 requires that we determine whether the benefits of our tax positions are more likely than not of being sustained upon audit based on the technical merits of the tax position. For tax positions that are more likely than not of being sustained upon audit, we recognize the largest amount of the benefit that is more likely than not of being sustained in our consolidated financial statements. For tax positions that are not more than likely than not of being sustained upon audit, we do not recognize any portion of the benefits in our consolidated financial statements. The provisions of FIN 48 also provide guidance on derecognition, classification, interest and penalties, accounting in interim periods, and disclosure.

The cumulative effect of the adoption of the recognition and measurement provisions of FIN 48 resulted in no change to the January 1, 2007 balance of retained earnings. Our policy for interest and penalties related to income tax exposures is to recognize interest and penalties as incurred within the provision for income taxes in the consolidated statements of operations.

Accumulated Other Comprehensive Income and Comprehensive Loss

Amounts recorded in accumulated other comprehensive income of $0.5 million as of March 31, 2007 represent unrealized holding gains on available-for-sale securities, net of income taxes of $0.3 million.

Including these unrecognized gains or losses, our comprehensive loss for the three months ended March 31, 2007 was $8.5 million.

Statutory accounting practices

NLASCO is required to report its results of operations and financial position to insurance regulatory authorities based upon statutory accounting practices (SAP). One significant difference between SAP and generally accepted accounting principles (GAAP) is that under SAP NLASCO is required to expense all sales and other policy acquisition costs as they are incurred rather than capitalizing and amortizing them over the expected life of the policy as required by GAAP. The immediate charge off of sales and acquisition expenses and other conservative valuations under SAP generally cause a lag between the sale of a policy and the emergence of reported earnings. Because this lag can reduce the Company s gain from operations on a SAP basis, it can have the effect of reducing the amount of funds available for dividends from insurance companies. A second significant difference is that under SAP, certain assets are designated as nonadmitted and are charged directly to unassigned surplus, whereas under GAAP, such assets are included in the balance sheet net of an appropriate valuation reserve. A third significant difference between SAP and GAAP is that under SAP, investments are carried at amortized book value and under GAAP, investments are carried at fair value. A fourth significant difference is that surplus notes are classified as capital and surplus under SAP but classified as notes payable under GAAP.

Recent Statements of Financial Accounting Standards

In September 2006, the FASB issued SFAS No.157, *Fair Value Measurement* (SFAS No. 157), which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under GAAP. SFAS No. 157 provides a common definition of fair value to be used throughout GAAP. The FASB believes that the new standard will make the measurement of fair value more consistent and comparable and improve disclosures about those measures. SFAS No. 157 is effective for companies with fiscal years beginning after November 15, 2007 and we are still evaluating its impact on our financial position and results of operations.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FAS 115* (SFAS No. 159). SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS No. 159 is expected to expand the use of fair value measurement, which is consistent with the Board s long-term measurement objectives for accounting for financial instruments. SFAS No. 159 is effective for companies with fiscal years beginning after November 15, 2007. Early adoption is permitted provided we also elect to apply the provisions of SFAS No. 157. We are still evaluating the impact that SFAS No. 159 will have on our financial position, results of operations and cash flows.

2. NLASCO Acquisition and Associated Equity Issuances

On January 31, 2007, we acquired all of the stock of NLASCO, a privately held property and casualty insurance holding company. In exchange for the stock, NLASCO s shareholders, consisting of C. Clifton Robinson and affiliates, received $105.75 million in cash and 1,218,880 shares of ARC common stock for a total consideration of $119.1 million. In addition, Flexpoint Fund, L.P., a fund managed by Flexpoint Partners, LLC of Chicago, Illinois, invested $20 million to purchase 2,154,763 shares of common stock of the Company at the leading ten-day average market price of our common stock on the date the agreement was signed, subject to certain anti-dilution provisions.

In order to raise $80 million to provide a source of funding for a portion of the acquisition of NLASCO, we conducted a rights offering to our stockholders. In the rights offering, all holders of ARC common stock as of the record date of December 19, 2006 received one non-transferable right to purchase approximately 0.242 shares of common stock of the Company for each share held. The price at which the additional shares were purchased was $8.00 per share. The rights offering expired on January 23, 2007, and the company issued approximately 7.8 million shares of common stock to existing shareholders on that date. In addition, Gerald J. Ford and certain affiliates controlled by him purchased approximately 1.8 million shares that they would have been entitled to in the rights offering in a separate private placement transaction. Gerald J. Ford, one of the Company s directors and the beneficial owner of approximately 17.6% of ARC s common stock as of the record date, and certain of his affiliates also backstopped the rights offering and purchased another approximately 400,000 shares that were not purchased in the rights offering by the stockholders of record on the record date, at the rights offering price per share of $8.00.

NLASCO has a history of producing consistent profitability and their expertise in underwriting insurance products for manufactured homes will create strategic opportunities consistent with ARC s existing customer base. The results of NLASCO s operations for the two months ended March 31, 2007 are included in these consolidated financial statements.

The total cash and equity consideration paid for the acquisition of NLASCO is as follows (in thousands):

Purchase price paid in cash	$ 105,750
Fair value of shares issued to shareholder of NLASCO	13,359
Total consideration received by seller	119,109
Other acquisition expenditures	10,365
Total cash and equity consideration	$ 129,474

The source of funds for the above cash and equity consideration is as follows (in thousands):

Cash received from Flexpoint Partners for common stock	$ 20,000
Cash raised in the rights offering	80,000
Fair value of shares issued to shareholder of NLASCO	13,359
Consideration paid by ARC from existing lines of credit	16,115
	$ 129,474

The total purchase price of NLASCO including liabilities assumed in the acquisition consists of the following (in thousands).

Total cash and equity consideration	$ 129,474
Notes payable assumed at fair value (including $5.6 million paid by ARC)	56,680
Loss and loss adjustment expense liability assumed	21,609
Unearned premiums assumed	49,571
Accounts payable and other liabilities assumed	8,428
Total purchase price including transaction costs and assumed liabilities	$ 265,762

Our purchase price allocation is as follows (in thousands).

Tangible assets at fair value	$ 32,780
Investments, cash and cash equivalents at fair value	166,443
Deferred income tax asset at fair value	24,782
Finite lived intangible assets	14,700
Goodwill	24,057
Other indefinite lived intangibles	3,000
	$ 265,762

We have prepared the following unaudited pro forma income statement information as if the NLASCO acquisition had occurred on January 1, 2006. The pro forma data is not necessarily indicative of the results that actually would have occurred if we had consummated the acquisition on January 1, 2006 (in thousands).

	Three Months Ended March 31,	
	2007	**2006**
Revenue	$ 93,588	$ 91,116
Total expenses	97,163	93,164
Interest income	(494)	(423)
Loss from continuing operations before income taxes and allocation to minority interest	(3,081)	(1,625)
Income tax expense from continuing operations	(2,052)	(2,277)
Loss from continuing operations before allocation to minority interest	(5,133)	(3,902)
Minority interest	145	110
Loss from continuing operations	(4,988)	(3,792)
Discontinued operations	(124)	6,940
Net (loss) income	$ (5,112)	$ 3,148
Net (loss) income attributable to common stockholders	$ (7,690)	$ 570
Basic (loss) income per share attributable to common stockholders	$ (0.14)	$ 0.01
Diluted (loss) income per share attributable to common stockholders	$ (0.14)	$ 0.01
Shares outstanding at March 31, 2007	56,392	56,392

3. Rental and Other Property, Net

The following summarizes rental and other property (in thousands).

	March 31, 2007	**December 31, 2006**
Land	$ 194,306	$ 194,306
Improvements to land and buildings	1,194,419	1,193,483
Rental homes and improvements	271,759	270,431
Furniture, equipment and vehicles	16,572	14,142
Subtotal	1,677,056	1,672,362
Less accumulated depreciation:		
On improvements to land and buildings	(222,699)	(210,483)
On rental homes and improvements	(69,325)	(63,092)
On furniture, equipment and vehicles	(10,438)	(8,223)
Rental and other property, net	$ 1,374,594	$ 1,390,564

4. Investments

The amortized cost (original cost for equity securities), gross unrealized holding gains and losses, and fair value of available-for-sale and held-to-maturity securities by major security type and class of security at March 31, 2007 were as follows (in thousands).

	March 31, 2007			
	Cost and Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
Available-for-sale securities:				
Fixed maturities:				
Government securities.	$ 52,832	$ 354	$	$ 53,186
Mortgage-backed securities.	17,193	158	(5)	17,346
Corporate debt securities	39,437	218		39,655
	109,462	730	(5)	110,187
Equity securities.	9,527	29		10,176
	118,989	759	(5)	120,363
Held-to-maturity securities:				
Fixed maturities:				
Government securities.	6,472	4		6,476
	$ 125,461	$ 763	$ (5)	$ 126,839

Fair values of investment securities are based on quoted market prices or dealer quotes, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities. The notes payable are periodically adjusted to market interest rates, therefore, the unpaid principal balance of the loan approximates fair value. Gross realized investment gains and losses for the two months ended March 31, 2007 are summarized as follows (in thousands).

	Two Months Ended March 31, 2007		
	Gross Gains	Gross Losses	Total
Fixed maturities	$ 6	$	$ 6
Equity securities	72	(12)	60
	$ 78	$ (12)	$ 66

Expected maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without penalties. The schedule of fixed maturities available-for-sale and held-to-maturity at March 31, 2007 by contractual maturity is as follows (in thousands).

	March 31, 2007 Amortized Cost	**Fair Value**
Available-for-sale fixed maturities:		
Due within one year	$ 17,136	$ 17,249
Due after one year through five years	35,925	36,163
Due after six years through ten years.	31,741	31,951
Due after ten years	7,429	7,478
Mortgage-backed securities	17,232	17,346
	$ 109,462	$ 110,187
Held-to-maturity debt securities:		
Due within one year	$ 1,622	$ 1,618
Due after one year through five years	4,439	4,439
Due after six years through ten years.		
Due after ten years	411	419
	$ 6,472	$ 6,476

Net investment income for the two months ended March 31, 2007 is as follows (in thousands).

	Two Months Ended March 31, 2007
Gross investment income	
Cash equivalents	$ 292
Fixed maturities	959
Equity securities	70
	1,321
Other income net of expenses	10
Net investment income	$ 1,331

At March 31, 2007, the Company had on deposit in custody for various State Insurance Departments investments with carrying values of approximately $8 million.

5. Disclosures About the Fair Value of Financial Instruments

In the normal course of business, the Company invests in various financial assets and incurs various financial liabilities. The fair value estimates of financial instruments presented below are not necessarily indicative of the amounts the Company might pay or receive in actual market transactions. Potential taxes and other transaction costs have not been considered in estimating fair value. The disclosures that follow do not reflect the fair value of the Company as a whole since a number of the Company s significant assets (including deferred policy acquisition costs, land and buildings, deferred income taxes) and liabilities are not considered financial instruments and are not carried at fair value. Other assets and liabilities considered financial instruments such as cash and cash equivalents, premiums receivable, reinsurance receivable, prepaid reinsurance premiums, loss and loss adjustment expenses outstanding, unearned premiums, and reinsurance balances payable are generally of a short-term nature. Their carrying values are deemed to approximate fair value.

	March 31, 2007 Carrying Value	**Fair Value**
Financial assets (in thousands)		
Fixed maturities	$ 116,659	$ 116,663
Equity securities	10,176	10,176
Financial liabilities (in thousands)		
Notes payable	$ 1,107,213	$ 1,121,805

Fair values of investment securities are based on quoted market prices or dealer quotes, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities. The notes payable are periodically adjusted to market interest rates plus applicable margin, therefore, the unpaid principal balance of the loan approximates fair value.

6. Deferred Acquisition Costs

Policy acquisition expenses, primarily commissions, premium taxes and underwriting expenses related to issuing a policy incurred by NLASCO are deferred and charged against income ratably over the terms of the related policies. The activity in deferred acquisition costs for the two months ended March 31, 2007 is as follows (in thousands).

	Two Months Ended March 31, 2007
Beginning of period deferred acquisition costs	$
Acquisition expenses	8,876
Amortization charged to income	(5,792)
End of period deferred acquisition costs	$ 3,084

7. Notes Payable

The following table sets forth certain information regarding our notes payable (in thousands).

	March 31, 2007	December 31, 2006
Senior fixed rate mortgage due 2009, 5.05% per annum	$ 84,322	$ 84,689
Senior fixed rate mortgage due 2012, 7.35% per annum	276,708	277,616
Senior fixed rate mortgage due 2014, 5.53% per annum	188,655	189,407
Senior fixed rate mortgage due 2016, 6.24% per annum	170,000	170,000
Senior variable rate mortgage due 2009, one-month LIBOR plus 0.80% per annum (6.12% at March 31, 2007)	60,000	60,000
Various individual fixed rate mortgages due 2007 through 2031, averaging 7.16% per annum at March 31, 2007	127,821	128,567
Floorplan line of credit due 2007, ranging from prime plus 0.75% to prime plus 4.00% per annum (9.00% at March 31, 2007)	1,641	2,664
Trust preferred securities due 2035, three-month LIBOR plus 3.25% per annum (8.60% at March 31, 2007)	25,780	25,780
Consumer finance facility due 2008, one-month LIBOR plus 3.00% per annum (8.32% at March 31, 2007)	13,019	
Lease receivable facility due 2008, one-month LIBOR plus 4.125% per annum (9.445% at March 31, 2007)	10,000	10,000
Senior exchangeable notes due 2025, 7.50% per annum	96,600	96,600
Insurance company line of credit due October 2007, base rate less 0.5% per annum (8.25% at March 31, 2007)	4,018	
NLIC surplus note payable due May 2033, three-month LIBOR plus 4.10% (9.45% at March 31, 2007)	10,000	
NLIC surplus note payable due September 2033, three-month LIBOR plus 4.05% (9.40% at March 31, 2007)	10,000	
ASIC surplus note payable due April 2034, three-month LIBOR plus 4.05% (9.40% at March 31, 2007)	7,500	
Insurance company note payable due March 2035, three-month LIBOR plus 3.40% (8.75% at March 31, 2007)	20,000	
Other loans	1,149	1,177
	$ 1,107,213	$ 1,046,500

Senior Fixed Rate Mortgage Due 2009

We entered into the Senior Fixed Rate Mortgage due 2009 on February 18, 2004, in connection with the completion of our IPO and the Hometown acquisition. It is an obligation of certain real property subsidiaries of the OP and is collateralized by 26 manufactured home communities owned by these subsidiaries. The Senior Fixed Rate Mortgage due 2009 bears interest at a fixed rate of 5.05%, is being amortized based on a 30-year amortization schedule and matures on March 1, 2009. Pursuant to the terms of the mortgage agreement, we have established reserves relating to the mortgaged properties for real estate taxes, insurance, capital spending and property operating expenditures. The Senior Fixed Rate Mortgage due 2009 contains customary defeasance-based prepayment penalties for repayments made prior to maturity.

Senior Fixed Rate Mortgage Due 2012

We entered into the Senior Fixed Rate Mortgage due 2012 on May 2, 2002. It is an obligation of certain of our special purpose real property subsidiaries and is collateralized by 98 manufactured home communities. The Senior Fixed Rate Mortgage due 2012 bears interest at a fixed rate of 7.35% per annum, is amortized based on a 30-year schedule and matures on May 1, 2012. Pursuant to the terms of the mortgage agreement, we have established reserves relating to the mortgaged properties for real estate taxes, insurance, capital spending and property operating expenditures. The Senior Fixed Rate Mortgage due 2012 contains customary defeasance-based prepayment penalties for repayments made prior to maturity.

Senior Fixed Rate Mortgage Due 2014

We entered into the Senior Fixed Rate Mortgage due 2014 on February 18, 2004 in connection with the completion of our IPO and the Hometown acquisition. It is an obligation of certain real property subsidiaries of the OP and is collateralized by 43 manufactured home communities owned by these subsidiaries. The Senior Fixed Rate Mortgage due 2014 bears interest at a fixed rate of 5.53% per annum, is amortized based on a 30-year schedule and matures on March 1, 2014. Pursuant to the terms of the mortgage agreement, we have established reserves relating to the mortgaged properties for real estate taxes, insurance, capital spending and property operating expenditures. The Senior Fixed Rate Mortgage due 2014 contains customary defeasance-based prepayment penalties for repayments made prior to maturity.

Senior Fixed Rate Mortgage Due 2016; Senior Variable Rate Mortgage Due 2009 (repaid and terminated Senior Variable Rate Mortgage Due 2007 and Revolving Credit Mortgage Facility)

On July 11, 2006, we entered into a $230 million mortgage debt facility. Approximately $116.8 million of the proceeds were used to repay and terminate our Senior Variable Rate Mortgage and approximately $58.8 million of the proceeds were used to repay and terminate our Revolving Credit Mortgage Facility. The Loan Agreement is comprised of two components (collectively, the Loan): a $170 million 10-year fixed rate mortgage debt component and a $60 million 3-year floating rate mortgage debt component with two one-year (no-fee) extension options. The fixed rate component bears interest at 6.239% and requires interest-only payments for the term of the loan. The floating rate component is adjusted monthly, bears interest at one-month LIBOR plus 80 basis points (6.12% at March 31, 2007 and capped at 7.3%) and requires interest-only payments for the term of the loan. The loan is secured by 59 manufactured housing communities located in 18 states as well as an assignment of leases and rents associated with the mortgaged property. The loan is non-recourse with the exception that the repayment of the indebtedness is guaranteed by the OP pursuant to a guaranty of non-recourse obligations in the event of declaration of bankruptcy; interference with any of the lenders rights, and asset transfers and other activities in violation of the loan documents. Under the provisions of the loan agreement, we have the right to prepay any portion of the floating rate component, with or without release of the mortgaged property, without penalty. Subsequent to a prepayment of the entire floating rate component of the loan, we have the option to prepay a fixed portion of the loan subject to prepayment fees, yield maintenance or defeasance in accordance with the terms of the loan agreement.

Various Individual Fixed Rate Mortgages

We have assumed various individual fixed rate mortgages in connection with the acquisition of various properties that were encumbered at the time of acquisition as follows:

a) Mortgages assumed as part of individual property purchases. These notes total approximately $34.1 million at March 31, 2007, mature from 2007 through 2028 and have an average effective

interest rate of 7.23%. These mortgages are secured by 11 specific manufactured home communities.

b) Mortgages assumed in conjunction with the Hometown acquisition. These notes total approximately $66.7 million, mature from 2008 through 2031 and carry an average effective interest rate of 7.12%. These mortgages are secured by 12 specific manufactured home communities and are subject to early pre-payment penalties, the terms of which vary from mortgage to mortgage.

c) Notes assumed in conjunction with the D.A.M. portfolio purchase. These notes total approximately $27.0 million, mature in 2008 and carry an average effective annual interest rate of 7.18%. These mortgages are secured by 23 specific manufactured home communities.

Floorplan Lines of Credit

On November 11, 2005, we amended our floorplan line of credit to provide borrowings of up to $35.0 million, secured by manufactured homes in inventory. Under the amended lines of credit, the lender will advance 75% of the cost of manufactured homes. Repayments of borrowed amounts are due upon sale or lease of the related manufactured home. Advances under the amended lines of credit will bear interest ranging from the prime rate plus 0.75% to the prime rate plus 4.00% (averaging 9.00% at March 31, 2007) based on the length of time each advance has been outstanding. Monthly curtailment payments are required for unsold homes beginning 360 days following the purchase of the home. The required curtailment payment will be between 3.00% and 5.00% of the home s original invoice amount depending on the type of home and the number of months since the home s purchase. The amended lines of credit require us to maintain a minimum tangible net worth, a maximum debt to tangible net worth ratio of 3 to 1, and minimum cash and cash equivalents of $15.0 million, all as defined in the agreement. As amended, the minimum tangible net worth required is $385.0 million from January 1, 2007 through September 13, 2007, the due date of the line. We are in compliance with all financial covenants of the line of credit as of March 31, 2007. The line of credit is subject to a commitment fee of $250,000, an unused line fee of .25% per annum and a termination fee of 1.00% to 3.00%, based on the termination date.

Trust Preferred Securities Due 2035

On March 15, 2005, the Company issued $25.8 million in unsecured trust preferred securities. The $25.8 million trust preferred securities bear interest at three-month LIBOR plus 3.25% (8.60% at March 31, 2007). Interest on the securities is paid on the 30th of March, June, September and December of each year. The Company may redeem these securities on or after March 30, 2010 in whole or in part at principal amount plus accrued interest. The securities are mandatorily redeemable on March 15, 2035 if not redeemed sooner.

Consumer Finance Facility

We entered into the Retail Home Sales and Consumer Finance Debt Facility (the Consumer Finance Facility) on February 18, 2004, in connection with the completion of our IPO and the Hometown acquisition and amended it in April 2005 in connection with entering into a two-year, $75.0 million secured revolving lease receivables credit facility (see Lease Receivables Facility below). The Consumer Finance Facility has a total commitment of $125.0 million and a term of four years. This facility is an obligation of a subsidiary of our OP, and borrowings under this facility are secured by manufactured housing conditional sales contracts. Borrowings under the facility are limited by specified borrowing base requirements related to the value of the collateral securing the facility ($14.9 million at March 31, 2007). The facility bears interest at a variable rate based upon a spread of 3.00% over the one-month LIBOR (8.32% at March 31, 2007). During the first quarter of 2007, we paid a commitment fee of 0.25% of the amended committed

amount. Advances under the facility are subject to a number of conditions, including certain underwriting and credit screening guidelines and the conditions that the home must be located in one of our communities, the loan term may not exceed 12 years for a single-section home or 15 years for a multi-section home and the loan amount shall not exceed 90% of the value of the home securing the conditional sales contract.

The Consumer Finance Facility was amended for financial covenants in October 2005. The amended line of credit requires the OP to maintain a minimum tangible net worth, a maximum debt to tangible net worth ratio of 3 to 1, and minimum cash and cash equivalents of $15.0 million, all as defined in the agreement. As amended, the minimum tangible net worth required is $385.0 million from January 1, 2007 through December 31, 2007, and $355.0 million from January 1, 2008 through February 18, 2008. We were in compliance as of March 31, 2007 with all financial covenants under the amended line of credit.

The availability of advances under the Consumer Finance Facility is subject to certain conditions that are beyond our control. Conditions that could result in our inability to draw on these facilities include a downgrade in the credit rating of the lender and the absence of certain markets for financing debt obligations secured by securities or mortgage loans. Funding under this facility may also be denied if the lender determines that the value of the assets serving as collateral would be insufficient to maintain the required 75% loan-to-value ratio upon giving effect to a request for funding. The lender can also at any time require that we prepay amounts funded or provide additional collateral if, in its judgment, this is necessary to maintain the 75% loan-to-value ratio.

Lease Receivables Facility

On April 6, 2005, the Company entered into a two-year, $75.0 million secured revolving credit facility (the Lease Receivables Facility) with Merrill Lynch Mortgage Capital Inc. to be used to finance the purchase of manufactured homes and for general corporate purposes. In October 2005, we amended our lease receivables facility to increase the size of the facility from $75 million to $150 million. The amendment also (i) increased the limit on borrowings under the lease receivables facility from an amount equal to approximately 55% of the net book value of the eligible manufactured housing units owned by two of our indirect wholly owned subsidiaries, ARC Housing LLC and ARC HousingTX LP (collectively, Housing) and located in ARC s communities, to 65%, subject to certain other applicable borrowing base requirements, (ii) increased the interest rate on borrowings under the facility from 3.25% plus one-month LIBOR to 4.125% plus one-month LIBOR (9.445% at March 31, 2007), and (iii) extended the maturity of the facility from March 31, 2007 to September 30, 2008.

The amended line of credit requires the OP to maintain a minimum tangible net worth, a maximum debt to tangible net worth ratio of 3 to 1, and minimum cash and cash equivalents of $15.0 million, all as defined in the agreement. As amended, the minimum tangible net worth required is $385.0 million from January 1, 2007 through December 31, 2007, and $355.0 million from January 1, 2008 through September 30, 2008. We were in compliance as of March 31, 2007 with all financial covenants under the amended line of credit. Borrowings under the Lease Receivables Facility are secured by an assignment of all lease receivables and rents, an assignment of the underlying manufactured homes and a pledge by ARCHC LLC and ARC Housing GP LLC of 100% of the outstanding equity in Housing. Interest is payable monthly.

Senior Exchangeable Notes Due 2025

In August 2005, our OP issued $96.6 million aggregate principal amount of 7.50% senior exchangeable notes due 2025 to qualified institutional buyers in a private transaction. The notes are senior unsecured obligations of the OP and are exchangeable, at the option of the holders, into shares of ARC common stock at an initial exchange rate of 69.8812 shares per $1,000 principal amount of the notes (equal

to an initial exchange price of approximately $14.31 per share), subject to adjustment and, in the event of specified corporate transactions involving ARC or the OP, an additional make-whole premium. Upon exchange, the OP shall have the option to deliver, in lieu of shares of ARC common stock, cash or a combination of cash and shares of ARC common stock.

According to the terms of the notes, their initial exchange rate is adjusted for certain events, including the issuance to all holders of ARC common stock of rights entitling them to purchase ARC common stock at less than their current market price. Accordingly, as a result of our rights offering in January 2007, in which we offered all holders of ARC common stock the right to purchase shares at $8.00 per share, the initial exchange rate of the notes was adjusted to 73.95 shares per $1,000 principal amount of the notes (equal to an initial exchange rate of $13.52 per share).

Prior to August 20, 2010, the notes are not redeemable at the option of the OP. After August 20, 2010, the OP may redeem all or a portion of the notes at a redemption price equal to the principal amount plus accrued and unpaid interest, if any, on the notes, if the closing price of ARC common stock has exceeded 130% of the exchange price for at least 20 trading days in any consecutive 30-trading day period.

Holders of the notes may require the OP to repurchase all or a portion of the notes at a purchase price equal to the principal amount plus accrued and unpaid interest, if any, on the notes on each of August 15, 2010, August 15, 2015, and August 15, 2020, or after the occurrence of certain corporate transactions involving ARC or the OP.

Insurance Company Line of Credit

Our insurance subsidiary has a line of credit with a financial institution. The line allows for borrowings by NLASCO up to $5 million and is secured by substantially all of NLASCO s assets. The line of credit bears interest equal to a base rate less 0.5% (8.25% at March 31, 2007) which is due monthly. The line matures in October 2007.

NLIC Surplus Notes Payable

NLIC has two unsecured $10 million surplus notes payable to unaffiliated companies. The surplus notes payable bear interest at three-month LIBOR plus 4.05% and three-month LIBOR plus 4.10% (9.40% and 9.45% at March 31, 2007). Interest is due quarterly and principal is due at maturity in May 2033 and September 2033. The surplus notes are subordinated in right of payment to all policy claims and other indebtedness of NLIC. Further, all payments of principal and interest require the prior approval of the Insurance Commissioner of the State of Texas and are only payable to the extent that the surplus of NLIC exceeds $30 million.

ASIC Surplus Note Payable

ASIC has an unsecured surplus note payable to an unaffiliated company. The surplus note payable bears interest at three-month LIBOR plus 4.05% (9.40% at March 31, 2007). Interest is due quarterly and principal is due at maturity. The surplus note is subordinated in right of payment to all policy claims and other indebtedness of ASIC. Further, all payments of principal and interest require the prior approval of the Insurance Commissioner of the State of Texas and are only payable to the extent that the surplus of ASIC exceeds $15 million.

Insurance Company Notes Payable

NLASCO has an unsecured $20 million note payable to an unaffiliated company which bears interest equal to the three-month LIBOR plus 3.40% (8.75% at March 31, 2007). Interest is due quarterly and the principal is due at maturity in March 2035.

NLASCO s loan agreements relating to the notes payable contain various covenants pertaining to limitations on additional debt, dividends, and officer and director compensation, and minimum capital requirements. The Company was in compliance with the covenants as of March 31, 2007.

8. Reserve for Losses and Loss Adjustment Expenses

A roll-forward of the reserve for losses and loss adjustment expenses for the two months ended March 31, 2007 is as follows (in thousands).

Balance February 1, 2007	$ 21,609
Less reinsurance recoverables	(1,509)
Net balance at February 1, 2007	20,100
Losses and loss adjustment expenses incurred	8,877
Loss payments	(8,407)
Net balance at March 31, 2007	20,570
Plus reinsurance recoverables	1,806
Balance at March 31, 2007	$ 22,376

The reserve for losses and loss adjustment expenses includes amounts that may be due to or from the sellers of NLASCO by January 2010 based on actual losses incurred applicable to the reserve as of the acquisition date.

9. Equity and Minority Interest Related Transactions

At March 31, 2007, minority interest consisted of 1,411,350 OP Units that were issued to various limited partners. Each OP Unit outstanding is paired with 1.9268 shares of our special voting stock (each a Paired Equity Unit) that allows each holder to vote an OP Unit on matters as if it were a common share of our stock. Each OP Unit is redeemable for cash, or at our election, 1.06 shares of our common stock. During the first quarter of 2007, we redeemed approximately 44,265 OP Units for 46,841 shares of our common stock valued at $0.6 million.

The PPUs outstanding as of December 31, 2006 consisted of 705,688 Series C units. The Series C PPUs carried a liquidation preference of $25 per unit and earned cash distributions at the rate of 6.25% per annum, payable quarterly. In January 2007, all 705,688 units of our Series C PPUs were redeemed according to their terms for 1,628,410 shares of ARC common stock.

We have recorded an equity transfer adjustment between additional paid-in capital and the minority interest in our consolidated balance sheet as of March 31, 2007 to account for changes in the respective ownership in the underlying equity of the Operating Partnership.

All retained earnings of our insurance subsidiary are unappropriated.

On March 14, 2007, the board of directors declared a quarterly cash dividend of $0.515625 per share for its Series A Cumulative Redeemable Preferred Stock. The dividend was paid on April 30, 2007 to shareholders of record on April 13, 2007. The Board reviews the payment of dividends on a quarterly basis.

In March 2007, four senior executives of ARC were granted options to acquire a total of 25,000 shares of common stock at $11.28 per share to compensate for dilution from the rights offering.

The following summarizes the activity of the minority interest in the Operating Partnership (in thousands):

Minority interest at December 31, 2006	$ 28,142
Minority interest allocation	(275)
Transfer from stockholders equity	1,371
Redemption of OP Units	(559)
Distributions to PPU holders	(67)
Redemption of Series C PPUs	(17,642)
Minority interest at March 31, 2007	$ 10,970

10. Reinsurance Activity

NLASCO limits the maximum net loss that can arise from large risks or risks in concentrated areas of exposure by reinsuring (ceding) certain levels of risk. Substantial amounts of business are ceded, and these reinsurance contracts do not relieve NLASCO from its obligations to policyholders. Such reinsurance includes quota share, excess of loss, catastrophe, and other forms of reinsurance on essentially all property and casualty lines of insurance. Failure of reinsurers to honor their obligations could result in losses to NLASCO; consequently, allowances are established for amounts deemed uncollectible. NLASCO evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. At March 31, 2007, reinsurance receivables with a carrying value of approximately $2.8 million were associated with a single reinsurer.

The effect of reinsurance on premiums written and earned for the two months ended March 31, 2007 is as follows (in thousands):

	Two Months Ended March 31, 2007	
	Written	**Earned**
Premiums from direct business	$ 20,929	$ 18,420
Reinsurance assumed	1,418	156
Reinsurance ceded	(2,757)	(1,857)
	$ 19,590	$ 16,719

25

11. Property Operations Expense

During the three months ended March 31, 2007 and 2006, we incurred property operations expense as follows (in thousands):

	Three Months Ended March 31, 2007	2006
Utilities and telephone	$ 7,560	$ 7,141
Salaries and benefits	5,512	4,970
Repairs and maintenance	2,403	1,823
Insurance	725	862
Bad debt expense	255	400
Professional services	218	311
Office supplies	162	161
Advertising	18	26
Other operating expense	736	728
	$ 17,589	$ 16,422

12. Retail Home Sales, Finance, Insurance and Other Operating Expense

During the three months ended March 31, 2007 and 2006, we incurred retail home sales, finance, insurance and other operating expense as follows (in thousands):

	Three Months Ended March 31, 2007	2006
Salaries and benefits	$ 815	$ 661
Lease commissions	434	581
Insurance	8	50
Professional services	210	233
Advertising	241	168
Other operating expense	156	205
	$ 1,864	$ 1,898

13. General and Administrative Expense

During the three months ended March 31, 2007 and 2006, we incurred general and administrative expense as follows (in thousands):

	Three Months Ended March 31, 2007	2006
Salaries and benefits	$ 3,295	$ 2,744
Travel	311	133
Professional services	845	631
Telephone	72	65
Office supplies	53	116
Insurance	219	257
Rent	154	64
Other administrative expense	436	411
	$ 5,385	$ 4,421

14. Discontinued Operations

As of December 31, 2005, the Company held 41 communities as discontinued operations and as of March 31, 2006 had closed sales for 27 of these communities comprising $34.2 million of cash proceeds net of related debt, defeasance and other closing costs of $34.3 million. Subsequent to March 31, 2006, we closed an additional 13 communities for $51.2 million of cash proceeds net of related debt, defeasance and other closing costs of $40.7 million. The remaining sales transaction is expected to close in 2008. There can be no assurance, however, that the Company will close the remaining community sale, or, if it closes, that it will close on the terms set forth in its contract.

In accordance with the provisions of Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-lived Assets, each of the communities designated as held for sale and not sold have been classified as discontinued operations as of March 31, 2007 and December 31, 2006. We have included $15.5 million and $15.3 million of net assets related to these communities as assets held for sale in the accompanying consolidated balance sheets as of March 31, 2007 and December 31, 2006, respectively, and $0.1 million and $0.2 million, respectively, of accounts payable and other obligations related to these communities as liabilities related to assets held for sale. In addition, we have recast the operations of each of these communities as discontinued operations in the accompanying statements of operations for the three months ended March 31, 2007 and 2006 and recorded a gain of $10.3 million related to the sale of the discontinued operations for the quarter ended March 31, 2006 in connection with these sales.

The following table summarizes combined balance sheet and income statement information for the discontinued operations noted above (in thousands):

	March 31, 2007	December 31, 2006
Assets Held for Sale		
Rental and other property, net	$ 13,347	$ 13,362
Goodwill	754	754
Prepaid expenses and other assets	1,359	1,210
	$ 15,460	$ 15,326
Liabilities Related to Assets Held for Sale		
Accounts payable and accrued expenses	$ 52	$ 236
Tenant deposits and other liabilities	11	11
	$ 63	$ 247

	Three Months Ended March 31, 2007	2006
Statement of Operations		
Revenue	$	$ 5,441
Operating expenses	(128)	(3,749)
Income from discontinued operations	$ (128)	$ 1,692

15. Income Taxes

At March 31, 2007, the Company has net operating loss carry-forwards for Federal income tax purposes, subject to certain limitations, of approximately $385 million and $368 million for regular income tax and alternative minimum tax, respectively. These net operating loss carry-forwards expire in 2018 through 2025. Losses from continuing operations during the quarter only partially offset the regular taxable earnings from discontinued operations for the quarter ending March 31, 2006 due to the allocation

of intra-period taxes as discussed below. The net operating loss carry-forwards for alternative minimum Federal income taxes generally are limited to offsetting 90% of the alternative minimum taxable earnings for a given period.

Based on our estimated composite Federal and state tax rate of 40% for our real estate business and 35% for our retail home, finance and insurance businesses, we recorded as of March 31, 2007, a deferred tax asset of approximately $162.2 million less a valuation allowance reserve of approximately $65.4 million and deferred tax liabilities of approximately $72.7 million. The 35% rate reflects a change from 40% due to the expectation that future taxable income of our insurance business will primarily be subject to Federal but not state income taxes. Insurance companies are generally not taxed in most states on income taxes as they pay premium taxes in states where they generate premium revenue. We experienced a reduction in our valuation allowance of $21.6 million due to the acquisition of NLASCO because the taxable income of this subsidiary will enable us to utilize $92.1 million of the net operating losses of an ARC subsidiary that is the parent of NLASCO, subject to limitation. We could experience circumstances in the future that result in a non-cash income tax benefit based on the timing of recognition of the tax benefit of our operating losses carried forward from prior years. Under current IRS rules, we can elect to return to REIT status after five years. There can be no assurances that the tax laws and regulations will not change or that we will change our REIT election status in five years.

The Company did not have aggregate income tax benefits or expense for the year ended December 31, 2006. We allocate income taxes between continuing and discontinued operations in accordance with Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes* (SFAS No. 109), particularly paragraph 140. We recognize income tax benefits in continuing operations on the effective rate method and income tax expense in discontinued operations without such pro-ration in accordance with Accounting Principles Bulletin 28, *Interim Financial Reporting* (APB 28) and FASB Interpretations 18, *Accounting for Income Taxes in Interim Periods An interpretation of APB Opinion No. 28* (FIN 18)

Effective January 1, 2007, we adopted FIN 48 which required the measurement of unrecognized tax benefits. Unrecognized tax benefits are the difference between a tax position taken, or expected to be taken in a tax return, and the benefit recognized for accounting purposes. For the period ending March 31, 2007 we have no unrecognized tax benefits.

We file tax returns as prescribed by the tax laws of the jurisdictions in which we operate. We are subject to tax audits in numerous jurisdictions in the U.S. until the applicable statute of limitations expires. The following is a summary of the tax years open to examination:

U.S. Federal 2003 through 2006
U.S. States 2002 through 2006

There are currently no U.S. Federal or state tax audits in process.

Under special IRS rules (the Section 382 Limitation), cumulative stock purchases by material shareholders exceeding 50% during a three year period can limit a company s future use of net operating losses (NOL s). We had a Section 382 ownership change in February 2004 at the time of the IPO. Due to section 382-limited NOLs expiring before they can be utilized, there is a potential loss of $11.5 million of NOLs. The deferred tax valuation allowance fully reserves for the tax effected amount.

The significant components of the provision for income taxes are as follows (in thousands):

	Three Months Ended March 31, 2007		
	Continuing Operations	Discontinued Operations	Total
Current tax expense	$	$	$
Deferred tax expense	(687)		(687)
Provision for income taxes	$ (687)	$	$ (687)

	Three Months Ended March 31, 2006		
	Continuing Operations	Discontinued Operations	Total
Current tax expense	$	$	$
Deferred tax expense			
Intra-period tax benefit (expense)	1,199	(4,795)	(3,596)
Provision for income taxes	$ 1,199	$ (4,795)	$ (3,596)

The provision for income taxes differs from the amount that would be computed by applying the statutory Federal income tax rate of 35% to income before income taxes as a result of the following (in thousands):

	Three Months Ended March 31, 2007		
	Continuing Operations	Discontinued Operations	Total
Tax at statutory rate	$ 2,046	$ 45	$ 2,091
Permanent differences	(86)	1	(85)
Increase in valuation allowance	(2,647)	(46)	(2,693)
Provision for income taxes	$ (687)	$	$ (687)

	Three Months Ended March 31, 2006		
	Continuing Operations	Discontinued Operations	Total
Tax at statutory rate	$ 4,401	$ (4,052)	$ 349
Permanent differences	(560)	(164)	(724)
State taxes	629	(579)	50
Intra-period tax limitation	(3,225)		(3,225)
Increase in valuation allowance	(46)		(46)
Provision for income taxes	$ 1,199	$ (4,795)	$ (3,596)

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amount of the assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The tax effects of significant temporary differences that give rise to the net deferred tax assets and liabilities are as follows (in thousands):

	March 31, 2007	**December 31, 2006**
Deferred Tax Assets		
Net operating loss carryforwards	$ 153,950	$ 150,834
Prepaid rent	268	249
Allowance for doubtful accounts and loan loss reserve	889	977
Goodwill	561	3,606
Notes payable	1,749	1,834
Accrued liabilities and other	1,603	1,533
Deferred revenue	490	340
Loss and loss adjustment expense discounting	625	
Securities available for sale	541	
Deferred compensation	1,093	
Loan origination costs	439	
Valuation allowance	(65,424)	(84,383)
Total gross deferred tax assets	$ 96,784	$ 74,990
Deferred Tax Liabilities		
Rental and other property, net	$ 62,774	$ 71,941