Forestar Real Estate Group Inc.
Form 10-Q
August 07, 2008

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

FORM 10-Q

þ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended June 30, 2008

OR

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from _________ to _________

Commission File Number: 001-33662

FORESTAR REAL ESTATE GROUP INC.
(Exact Name of Registrant as Specified in Its Charter)

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

1300 MoPac Expressway South, Suite 3S, Austin, Texas 78746
(Address of Principal Executive Offices, Including Zip Code)

(512) 433-5200
(Registrant s Telephone Number, Including Area Code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No o

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

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

Title of Each Class	Number of Shares Outstanding as of July 31, 2008
Common Stock, par value $1.00 per share	35,676,531

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PART I FINANCIAL INFORMATION

Item 1. ***Financial Statements***

FORESTAR REAL ESTATE GROUP INC.
Consolidated Balance Sheets

	(Unaudited) June 30, 2008	December 29, 2007
	(In thousands)	
ASSETS		
Cash and cash equivalents	$ 7,762	$ 7,520
Real estate	582,800	552,210
Investment in unconsolidated ventures	112,178	101,687
Timber	53,201	54,593
Receivables, net	4,439	3,767
Prepaid expense	2,421	2,267
Property and equipment, net	1,835	1,568
Deferred tax asset	8,193	5,106
Other assets	20,014	20,008
TOTAL ASSETS	$ 792,843	$ 748,726
LIABILITIES AND STOCKHOLDERS EQUITY		
Accounts payable	$ 8,288	$ 8,002
Accrued employee compensation and benefits	1,963	3,857
Accrued interest	1,250	896
Accrued property taxes	5,822	4,459
Other accrued expenses	15,023	15,318
Other liabilities	10,561	8,349
Debt	297,024	266,015
TOTAL LIABILITIES	339,931	306,896
COMMITMENTS AND CONTINGENCIES		
MINORITY INTEREST IN CONSOLIDATED VENTURES	7,985	8,629
STOCKHOLDERS EQUITY		
Preferred stock, par value $0.01 per share, 25,000,000 authorized shares, none issued		
Common stock, par value $1.00 per share, 200,000,000 authorized shares, 35,707,632 issued at June 30, 2008 and 35,380,385 issued at December 29, 2007	35,708	35,380
Additional paid-in capital	376,240	373,026
Retained earnings	34,153	24,795
Accumulated other comprehensive income	664	
Treasury stock, at cost, 85,801 shares at June 30, 2008	(1,838)	

TOTAL STOCKHOLDERS EQUITY	444,927	433,201
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 792,843	$ 748,726

Please read the notes to the consolidated financial statements.

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FORESTAR REAL ESTATE GROUP INC.
Consolidated Statements of Operations
(Unaudited)

	Second Quarter		First Six Months	
	2008	2007	2008	2007
	(In thousands, except per share amounts)			
REVENUES				
Real estate sales	$ 17,061	$ 40,304	$ 39,851	$ 61,571
Commercial operating properties and other	7,057	7,013	12,710	13,312
Real estate	24,118	47,317	52,561	74,883
Mineral resources	24,386	5,186	30,654	9,040
Fiber resources and other	3,093	3,782	5,605	6,818
	51,597	56,285	88,820	90,741
EXPENSES				
Cost of real estate sales	(8,479)	(13,708)	(21,986)	(26,372)
Cost of commercial operating properties and other	(4,564)	(4,862)	(8,429)	(8,810)
Cost of fiber resources and other	(925)	(443)	(1,471)	(1,822)
Other operating	(13,833)	(6,133)	(22,134)	(15,312)
General and administrative	(5,947)	(4,759)	(12,784)	(9,420)
	(33,748)	(29,905)	(66,804)	(61,736)
OPERATING INCOME	17,849	26,380	22,016	29,005
Equity in earnings of unconsolidated ventures	2,018	1,478	3,552	2,977
Minority interest in consolidated ventures	(530)	(2,595)	(1,030)	(4,029)
Interest expense	(5,002)	(2,534)	(10,668)	(4,241)
Other non-operating income	72	52	154	112
INCOME BEFORE TAXES	14,407	22,781	14,024	23,824
Income tax expense	(4,811)	(8,349)	(4,666)	(8,731)
NET INCOME	$ 9,596	$ 14,432	$ 9,358	$ 15,093
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING				
Basic	35,422	35,380	35,390	35,380
Diluted	36,117	35,380	36,098	35,380
NET INCOME PER COMMON SHARE				
Basic	$ 0.27	$ 0.41	$ 0.26	$ 0.43
Diluted	$ 0.27	$ 0.41	$ 0.26	$ 0.43

Please read the notes to the consolidated financial statements.

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FORESTAR REAL ESTATE GROUP INC.
Consolidated Statements of Cash Flows
(Unaudited)

	First Six Months 2008	First Six Months 2007
	(In thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 9,358	$ 15,093
Adjustments:		
Depreciation and amortization	3,467	1,323
Deferred income taxes	(3,443)	(1,593)
Equity in earnings of unconsolidated ventures	(3,552)	(2,977)
Distributions of earnings of unconsolidated ventures	883	1,593
Minority interest in consolidated ventures	1,030	4,029
Distributions to minority interests	(2,980)	(4,447)
Share-based compensation	3,528	1,542
Non-cash real estate cost of sales	20,863	21,478
Real estate development and acquisition expenditures	(50,834)	(85,309)
Reimbursements from utility or improvement districts	374	1,047
Other changes in real estate	(290)	(1,671)
Gain on termination of timber lease	(1,376)	
Cost of timber cut	1,258	1,952
Deferred income	2,331	
Asset impairments		1,500
Other	(821)	930
Changes in:		
Receivables	9	1,227
Prepaid and other	(794)	(341)
Accounts payable and other accrued liabilities	273	6,253
Net cash used in operating activities	(20,716)	(38,371)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Property, equipment, software and reforestation	(1,368)	(1,744)
Investment in unconsolidated ventures	(11,339)	(2,202)
Return of investment in unconsolidated ventures	4,375	2,800
Proceeds from sale of assets		657
Net cash used in investing activities	(8,332)	(489)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments of debt	(39,547)	(6,828)
Additions to debt	70,556	26,498
Note payable to Temple-Inland, net		24,718
Dividends and other transfers to Temple-Inland		(7,513)
Deferred financing fees	(1,078)	
Exercise of stock options	872	
Payroll taxes on restricted stock and stock options	(1,832)	
Tax benefit from share-based compensation	81	
Other	238	726

Net cash provided by financing activities	29,290	37,601
Net increase (decrease) in cash and cash equivalents	242	(1,259)
Cash and cash equivalents at beginning of period	7,520	10,350
Cash and cash equivalents at end of period	$ 7,762	$ 9,091

Please read the notes to the consolidated financial statements.

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FORESTAR REAL ESTATE GROUP INC.
Notes to the Consolidated Financial Statements
(Unaudited)

Note 1 Background

Prior to December 28, 2007, we were a wholly-owned subsidiary of Temple-Inland Inc. On December 28, 2007, Temple-Inland distributed all our issued and outstanding shares of common stock to its stockholders, and at the same time distributed to its stockholders all the issued and outstanding shares of common stock of Guaranty Financial Group, Inc., another wholly-owned subsidiary of Temple-Inland that operated its financial services business. As a result of the spin-off, our financial statements prior to 2008 reflect the historical accounts of the real estate development, minerals and fiber operations contributed to us and have been derived from the historical financial statements and accounts of Temple-Inland. In 2008, we changed our fiscal year from a 52/53 week year ending the Saturday closest to December 31 to a calendar year.

Note 2 Basis of Presentation

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

We prepared our unaudited interim financial statements in accordance with U.S. generally accepted accounting principles and Securities and Exchange Commission requirements for interim financial statements. As a result, they do not include all the information and disclosures required for complete financial statements. However, in our opinion, all adjustments considered necessary for a fair presentation have been included. Such adjustments consist only of normal recurring items unless otherwise noted. We make estimates and assumptions about future events. Actual results can, and probably will, differ from those we currently estimate including those related to allocating costs to real estate and measuring assets for impairment. These interim operating results are not necessarily indicative of the results that may be expected for the entire year. For further information, please read the financial statements included in our 2007 Annual Report on Form 10-K.

Certain prior year items have been reclassified to conform to the current year s presentation, including reclassification of cost of sales of $1,348,000 and general and administrative expenses of $646,000 to other operating expenses.

Note 3 New Accounting Pronouncements

In January 2008, two new accounting pronouncements were effective:

- Statement of Financial Accounting Standard (SFAS) No. 157, *Fair Value Measures* This standard defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. The adoption of this statement did not have a significant effect on our earnings or financial position.

- SFAS No. 159, *The Fair Value Options for Financial Assets and Financial Liabilities* This standard permits the election of fair value as the initial and subsequent measurement method for many financial assets and liabilities. Subsequent changes in the fair value would be recognized in earnings as they occur. We did not elect the fair value option.

In addition, there are three new accounting pronouncements that we will be required to adopt in first quarter 2009. Based on our current understanding, we do not expect that adoption of any of these pronouncements will have a significant effect on our earnings or financial position.

SFAS No. 141(R), *Business Combinations* This new standard requires most identifiable assets, liabilities, noncontrolling interests and goodwill acquired in a business combination to be recorded at full fair value. The new standard also changes the approach to determining the purchase price; the accounting for acquisition cost; and the accounting practices for acquired contingencies, restructuring costs, long-lived assets, share-based payment awards, indemnification costs and tax benefits.

SFAS No. 160, *Noncontrolling Interest in Consolidated Financial Statements* This new standard specifies that noncontrolling interests be reported as a part of equity, not as a liability or other item outside of equity. Currently, we report noncontrolling interests as a liability.

SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133* This new standard requires enhanced disclosures about derivative instruments including how and why they are used; how they are accounted for; and how they affect an entity s financial position, financial performance and cash flows.

Note 4 Real Estate

Real estate consists of:

	June 30, 2008	December 29, 2007
	(In thousands)	
Entitled, developed and under development land	$ 420,067	$ 388,493
Undeveloped land and land in the entitlement process	140,613	141,012
Commercial operating properties	43,746	43,479
	604,426	572,984
Accumulated depreciation	(21,626)	(20,774)
	$ 582,800	$ 552,210

Included in entitled, developed and under development land are the estimated cost of assets we expect to convey to utility or improvement districts of $57,234,000 at second quarter-end 2008 and $40,843,000 at year-end 2007. These costs relate to water, sewer and other infrastructure assets for which the utility or improvement districts have agreed to reimburse us, typically when these districts achieve adequate tax bases to support payment. We billed these districts $14,814,000 in first six months 2008 and $26,140,000 in first six months 2007, and we collected $374,000 in first six months 2008 and $1,047,000 in first six months 2007.

Depreciation expense, primarily related to commercial operating properties, was $852,000 in first six months 2008 and $1,006,000 in first six months 2007 and is included in other operating expense.

Note 5 Investment in Unconsolidated Ventures

At second quarter-end 2008, we had ownership interests ranging from 25 to 50 percent in 15 ventures that we account for using the equity method. We have no real estate ventures that are accounted for using the cost method. Our two largest ventures are CL Realty and Temco, in both of which we own a 50 percent interest and Cousins Real Estate Corporation owns the other 50 percent interest. Information regarding CL Realty and Temco follows:

CL Realty, L.L.C. was formed in 2002 for the purpose of developing residential and mixed-use communities in Texas and across the southeastern United States. At second quarter-end 2008, the venture had 15 residential and mixed-use communities, of which 10 are in Texas, 3 are in Florida and 2 are in Georgia.

Temco Associates, LLC was formed in 1991 for the purpose of acquiring and developing residential real estate sites in Georgia. At second quarter-end 2008, the venture had 5 residential and mixed-use communities, all of which are located in Georgia. The venture also owns approximately 6,100 acres of undeveloped land in Georgia.

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

	June 30, 2008				December 29, 2007			
	CL Realty	Temco	Other Ventures	Total	CL Realty	Temco	Other Ventures	Total
	(In thousands)							
Real estate	$ 124,378	$ 60,658	$ 147,092	$ 332,128	$ 122,659	$ 59,992	$ 75,061	$ 257,712
Total assets	125,375	61,958	159,167	346,500	124,419	63,481	125,323	313,223
Borrowings, principally non-recourse	5,563	3,300	59,211	68,074(a)	6,350	3,397	62,888	72,635(a)
Total liabilities	8,838	3,940	87,051	99,829	9,903	4,437	82,565	96,905
Equity	116,536	58,019	72,116	246,671	114,516	59,044	42,758	216,318
Our investment in real estate ventures								
Our share of their equity (b)	58,268	29,010	32,576	119,854	57,258	29,522	22,590	109,370
Unrecognized deferred gain (c)	(7,062)		(614)	(7,676)	(7,069)		(614)	(7,683)
Investment in real estate ventures	$ 51,206	$ 29,010	$ 31,962	$ 112,178	$ 50,189	$ 29,522	$ 21,976	$ 101,687

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

	Second Quarter		First Six Months	
	2008	2007	2008	2007
	(In thousands)			
Revenues:				
CL Realty(d)	$ 1,590	$ 6,520	$ 4,675	$ 7,970
Temco	1,613	2,501	2,290	3,595
Other ventures	3,461	5,064	6,711	7,625
Total	$ 6,664	$ 14,085	$ 13,676	$ 19,190
Earnings:				
CL Realty(d)	$ 3,094	$ 1,565	$ 5,407	$ 3,553
Temco	488	401	209	359
Other ventures	125	1,009	(136)	816
Total	$ 3,707	$ 2,975	$ 5,480	$ 4,728
Our equity in their earnings:				
CL Realty(c) (d)	$ 1,547	$ 782	$ 2,690	$ 1,776
Temco	244	201	103	180
Other ventures(b)	220	381	752	740

Recognition of deferred gain[c]	7	114	7	281
Total	$ 2,018	$ 1,478	$ 3,552	$ 2,977

(a) Includes current maturities of $24,915,000 at second quarter-end 2008 and $36,337,000 at year-end 2007.

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

(c) In 2003, we contributed real estate with a $13,800,000 carrying value to CL Realty in exchange for $13,800,000 cash and a 50 percent interest in the partnership. We deferred the $14,587,000 gain on the sale and are recognizing it as the partnership sells the real estate to third parties. The deferred gain is reflected as an offset to our investment in unconsolidated ventures.

(d) CL Realty revenues and earnings in first six months 2008 include $1,568,000 from leasing 241 net mineral acres to a third-party exploration and production company. Our share of earnings from this lease was $784,000 and is included in equity in earnings of unconsolidated ventures.

In first six months 2008, we invested $11,339,000 in these ventures and received $5,258,000 in distributions. In first six months 2007, we invested $2,202,000 in these ventures and received $4,393,000 in distributions. Distributions include both return of investments and distributions of earnings.

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Note 6 Debt

Debt consists of:

	June 30, 2008	December 29, 2007
	(In thousands)	
Term loan facility due in 2010, interest payable at LIBOR + 4% (6.47% at June 30, 2008)	$ 175,000	$ 175,000
Revolving loan facility due in 2010, interest payable at LIBOR + 4%	30,000	
Secured promissory note due in 2008, interest payable at 7.30%	16,142	16,431
Other indebtedness due through 2011 at variable interest rates based on prime (5.00% at June 30, 2008) and fixed interest rates ranging from 6.00% to 9.50%	75,882	74,584
	$ 297,024	$ 266,015

Our senior credit facility and other debt agreements contain terms, conditions and financial covenants customary for such agreements including minimum levels of interest coverage and limitations on leverage. At second quarter-end 2008, we had complied with the terms, conditions and financial covenants of these agreements.

Our senior credit facility provides for a $175,000,000 term loan and a $290,000,000 revolving line of credit. We may, upon notice to the lenders, request an increase in the credit facility to provide for a total of $500,000,000. The revolving line of credit includes a $100,000,000 sublimit available for letters of credit, of which $22,048,000 was outstanding at second quarter-end 2008. Total borrowings under our senior credit facility (including the face amount of letters of credit) may not exceed a borrowing base formula, and there is a $35,000,000 minimum liquidity requirement at each quarter-end. At second quarter-end 2008, we had $175,703,000 in net unused borrowing capacity under our senior credit facility.

All borrowings under the credit facility are secured by (a) a pledge of approximately 250,000 acres of undeveloped land, (b) assignments of current and future leases, rents and contracts, including our mineral leases, (c) a security interest in our primary operating account, (d) pledge of the equity interests in current and future material operating subsidiaries or joint venture interests, or if such pledge is not permitted, a pledge of the right to distributions from such entities, and (e) negative pledge (without a mortgage) on all other wholly-owned assets. The credit facility provides for releases of real estate provided that borrowing base compliance is maintained.

At second quarter-end 2008, unamortized fees related to our credit facility were $8,695,000 and are included in other assets. Amortization of these fees was $1,739,000 for first six months 2008 and is included in interest expense.

At second quarter-end 2008, commercial operating properties with a book value of $21,666,000 were subject to liens in connection with $16,142,000 of debt, and entitled, developed and under development land having a book value of $148,990,000 were subject to liens in connection with $75,882,000 of principally non-recourse debt.

Note 7 Derivative Instruments

We use interest rate agreements in the normal course of business to mitigate the risk inherent in interest rate fluctuations by entering into contracts with major U.S. securities firms. In first quarter 2008, we entered into a $100,000,000 notional amount interest rate swap agreement that matures in 2010.

Under this swap agreement, we pay a fixed interest rate of 6.57 percent and receive a floating interest rate of one month LIBOR plus 4 percent (6.47% at second quarter-end 2008). The interest rate swap was designed to offset the cash flow variability of probable interest rate payments associated with our variable-rate debt. The hedged cash flows are the interest rate payments associated with the first $100,000,000 of our variable-rate borrowings. Our interest rate swap meets the conditions required for effectiveness under the variable cash flows methodology of SFAS No. 133, *Accounting for Derivatives Instruments and Hedging Activities*. The effectiveness of the hedge relationship is periodically assessed by comparing the present value of the cumulative change in the expected future interest cash flows on the variable leg of the swap and the present value of the cumulative change in the expected future hedged cash flows. In first six months 2008, hedge ineffectiveness was not significant.

The fair value of the interest rate swap agreement was determined using quoted prices in active markets for identical assets (Level 1) under SFAS No. 157. At second quarter-end 2008, the fair value of the interest rate swap agreement was a $1,066,000 asset which is included in other assets. The effective change in fair value of our interest rate swap agreement, net of taxes, was $994,000 in second quarter 2008 and is included in other comprehensive income.

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Note 8 Contingencies

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

Liabilities in connection with environmental remediation arise from time to time in the ordinary course of doing business and we believe we have established adequate reserves for any probable losses. We own 288 acres near Antioch, California, portions of which were sites of a Temple-Inland paper manufacturing operation that need remediation. In second quarter 2008, we increased our reserves for environmental remediation by about $2,900,000. We estimate the cost we will likely incur to complete remediation activities will be about $6,250,000, which is included in other accrued expenses and will likely be paid in 2008 and 2009.

Note 9 Capital Stock

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

Please read Note 13 for information about additional shares of common stock that could be issued under terms of our share-based compensation plans.

As a result of our spin-off from Temple-Inland, all of Temple-Inland s outstanding share-based compensation awards were equitably adjusted into separate awards: one related to our common stock, one related to Temple-Inland common stock and one related to Guaranty common stock. All awards issued as part of this adjustment are subject to their original vesting schedules.

At second quarter-end 2008, Temple-Inland and Guaranty directors and employees held 82,000 equity-settled awards on our stock.

The following table summarizes outstanding stock option awards on our stock held by Temple-Inland and Guaranty directors and employees at second quarter-end 2008:

	Shares (In thousands)	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value (Current Value Less Exercise Price) (In thousands)
Outstanding	1,827	$ 19.35	6	$ 5,955
Exercisable	1,412	$ 16.84	5	$ 5,955

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Note 10 Other Comprehensive Income

Other comprehensive income consists of:

	Second Quarter		First Six Months	
	2008	2007	2008	2007
	(In thousands)			
Net income	$ 9,596	$ 14,432	$ 9,358	$ 15,093
Change in fair value of interest rate swap agreement, net of taxes	994		664	
Other comprehensive income	$ 10,590	$ 14,432	$ 10,022	$ 15,093

Note 11 Net Income per Share

We computed net income per share by dividing income by weighted average shares outstanding using the following:

	Second Quarter		First Six Months	
	2008	2007	2008	2007
	(In thousands)			
Weighted average common shares outstanding basic	35,422	35,380	35,390	35,380
Dilutive effect of stock options	511		509	
Dilutive effect of restricted stock and restricted stock units	184		199	
Weighted average common shares outstanding diluted	36,117	35,380	36,098	35,380

For second quarter and first six months 2007, we computed basic and diluted net income per share based upon the number of shares of our common stock distributed by Temple-Inland on December 28, 2007.

At second quarter-end 2008, the effect of 1,434,000 stock options and unvested restricted stock were not included in the computation of diluted weighted average shares outstanding because their impact would have been anti-dilutive.

Note 12 Segment Information

In first quarter 2008, we changed our reportable segments to reflect our post-spin management of the operations transferred to us from Temple-Inland. All prior period segment information has been reclassified to conform to the current presentation. We manage our operations through three segments: real estate, mineral resources and fiber resources. Real estate secures entitlements and develops infrastructure on our lands for single-family residential and mixed-use communities and manages our undeveloped land and commercial operating properties. Mineral resources manages our mineral interests, and fiber resources manages our timber and recreational leases.

We evaluate performance based on segment earnings before unallocated items and income taxes. Segment earnings consist of operating income, equity in earnings of unconsolidated ventures and minority interest expense in consolidated ventures. Unallocated items consist of general and administrative expense, share-based compensation, other non-operating income and expense and interest expense. All our revenues are derived from U.S. operations and all our assets are located in the U.S. For first six months 2008, revenues from one customer of our mineral resources segment represent about 14% of our total revenues.

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	Second Quarter 2008	Second Quarter 2007	First Six Months 2008	First Six Months 2007
	(In thousands)			
Revenues:				
Real estate	$ 24,118	$ 47,317	$ 52,561	$ 74,883
Mineral resources	24,386	5,186	30,654	9,040
Fiber resources	3,093	3,782	5,605	6,818
Total revenues	$ 51,597	$ 56,285	$ 88,820	$ 90,741
Segment earnings:				
Real estate	$ 874	$ 23,040	$ 4,417	$ 26,776
Mineral resources	23,247	4,693	29,752	8,072
Fiber resources	1,411	2,353	4,251	2,698
Total segment earnings	25,532	30,086	38,420	37,546
Items not allocated to segments [a]	(11,125)	(7,305)	(24,396)	(13,722)
Income before taxes	$ 14,407	$ 22,781	$ 14,024	$ 23,824

[a] Items not allocated to segments consists of:

	Second Quarter 2008	Second Quarter 2007	First Six Months 2008	First Six Months 2007
	(In thousands)			
General and administrative	$ (5,348)	$ (4,139)	$ (10,354)	$ (8,051)
Share-based compensation	(847)	(684)	(3,528)	(1,542)
Interest expense	(5,002)	(2,534)	(10,668)	(4,241)
Other non-operating income	72	52	154	112
	$ (11,125)	$ (7,305)	$ (24,396)	$ (13,722)

	June 30, 2008	December 29, 2007
	(In thousands)	
Assets:		
Real estate	$ 700,812	$ 658,813
Mineral resources	39	
Fiber resources	53,602	55,011
Assets not allocated to segments	38,390	34,902
Total assets	$ 792,843	$ 748,726

Note 13 Share-Based Compensation

Post-spin Awards

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

Cash-settled awards

Cash-settled awards vest 50 percent after year one and 50 percent after year two from the date of grant and provide for accelerated vesting upon retirement, death, disability or if there is a change in control. The following table summarizes the activity of awards granted under our plan for first six months 2008:

	Equivalent Units (In thousands)	Weighted Average Grant Date Fair Value	Aggregate Current Value (In thousands)
Non-vested as of December 29, 2007		$	
Granted	6	28.85	
Vested			
Forfeited	(1)	28.85	
Non-vested as of June 30, 2008	5	$ 28.85	$ 103

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Equity-settled awards

Equity-settled awards in the form of restricted stock units granted to our directors are fully vested at the time of grant and payable upon retirement. The following table summarizes the activity of awards granted under our plan for first six months 2008:

	Equivalent Units (In thousands)	Weighted Average Grant Date Fair Value	Aggregate Current Value (In thousands)
Non-vested as of December 29, 2007		$	
Granted	41	28.26	
Vested	(41)	28.26	
Forfeited			
Non-vested as of June 30, 2008		$	$

The total fair value of awards vested in first six months of 2008 was $1,147,000, of which $397,000 are deferred director fees.

Restricted stock

Restricted stock awards vest after three years if we achieve a minimum one percent annualized return on assets over such three-year period. The following table summarizes the activity of awards granted under our plan for first six months 2008:

	Restricted Shares (In thousands)	Weighted Average Grant Date Fair Value	Total Fair Value (In thousands)
Non-vested as of December 29, 2007		$	
Granted	139	28.75	
Vested			$
Forfeited	(6)	28.85	
Non-vested as of June 30, 2008	133	$ 28.74	

Stock options

Stock options have a ten-year term, generally become exercisable ratably over three to four years and provide for accelerated or continued vesting upon retirement, death, disability or if there is a change in control. Options were granted with an exercise price equal to the market value of our stock on the date of grant. The following table summarizes the activity of awards granted under our plan for first six months 2008:

	Weighted	Weighted Average	Aggregate Intrinsic Value

	Options Outstanding (In thousands)	Average Exercise Price per Share	Remaining Contractual Term (In years)	(Current Value Less Exercise Price) (In thousands)
Balance as of December 29, 2007		$		$
Granted	624	28.85		
Exercised				
Forfeited	(2)	28.85		
Balance as of June 30, 2008	622	$ 28.85	10	$
Options Exercisable as of June 30, 2008	14	28.85	10	$

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Stock options are valued based upon the Black-Scholes option pricing model. Awards granted in first six months 2008 were valued based upon the following assumptions:

Expected dividend yield	0.0%
Expected stock price volatility	31.0%
Risk-free interest rate	2.7%
Expected life of options in years	6
Weighted average estimated fair value of options granted	$10.22

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

Pre-spin Awards

Prior to the spin-off, we participated in Temple-Inland s share-based compensation plans, and as a result, certain of our directors and employees received share-based compensation in the form of restricted or performance stock units, restricted stock, or options to purchase shares of Temple-Inland s common stock. Concurrent with Temple-Inland s distribution of our common stock, all outstanding Temple-Inland awards were adjusted into three separate awards: one related to Forestar common stock, one related to Guaranty common stock and one related to Temple-Inland common stock.

In 2007, the expense for share-based compensation awards granted to our employees under Temple-Inland s plans was allocated to us by Temple-Inland. We continue to recognize share-based compensation expense over the remaining vesting periods associated with our employees and directors awards in Forestar, Guaranty and Temple-Inland stock.

Cash-settled awards

Cash-settled awards generally vest and are paid after three years from the date of grant or the attainment of defined performance goals, generally measured over a three-year period. A summary of cash-settled awards outstanding to our directors and employees at second quarter-end 2008, following the adjustments described previously, follows:

	Equivalent Units	Aggregate Current Value
	(In thousands)	
Awards on Forestar stock	38	$ 724
Awards on Guaranty stock	38	204
Awards on Temple-Inland stock	114	1,286
		$ 2,214

In first six months 2008, we paid $138,000 to settle vested cash awards.

Restricted stock

All outstanding restricted stock awards at year-end 2007 vested in first quarter 2008. The total fair value of these awards was $474,000.

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Stock options

Stock options have a ten-year term, generally become exercisable ratably over four years and provide for accelerated or continued vesting upon retirement, death, disability or if there is a change in control. Options were granted with an exercise price equal to the market value of Temple-Inland common stock on the date of grant. A summary of stock option awards outstanding to our directors and employees at second quarter-end 2008, following the adjustments described previously, follows:

	Shares (In thousands)	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value (Current Value Less Exercise Price) (In thousands)
Outstanding on Forestar stock	86	$ 21.12	6	$ 234
Outstanding on Guaranty stock	86	13.55	6	
Outstanding on Temple-Inland stock	256	16.84	6	182
				$ 416
Exercisable on Forestar stock	57	$ 17.64	5	$ 234
Exercisable on Guaranty stock	57	11.32	5	
Exercisable on Temple-Inland stock	172	14.07	5	182
				$ 416

The intrinsic value of options exercised in first six months 2008 was $128,000.

Share-Based Compensation Expense

Pre-tax share-based compensation expense for post-spin and pre-spin awards consists of:

	Second Quarter 2008	Second Quarter 2007	First Six Months 2008	First Six Months 2007
	(In thousands)			
Cash-settled awards	$ 55	$ 566	$ 195	$ 1,140
Equity-settled awards			750	
Restricted stock	328	34	517	74
Stock options	464	84	2,066	328
	$ 847	$ 684	$ 3,528	$ 1,542

The fair value of awards granted to retirement-eligible employees and expensed at the date of grant was $1,321,000 in first six months 2008.

Pre-tax share-based compensation expense is included in:

	Second Quarter	First Six Months

	2008	2007	2008	2007
	(In thousands)			
General and administrative	$ 598	$ 620	$ 2,429	$ 1,369
Other operating	249	64	1,099	173
	$ 847	$ 684	$ 3,528	$ 1,542

Unrecognized share-based compensation for post-spin awards not vested was $8,085,000 at second quarter-end 2008. It is likely that this cost will be recognized as expense over the next four years. Unrecognized share-based compensation for pre-spin awards not vested was $1,266,000 at second quarter-end 2008. It is likely that this cost will be recognized as expense over the next three years.

In connection with restricted stock vested and stock options exercised, we withheld shares having a value of $1,832,000 for payment of payroll taxes in first six months 2008. These shares are accounted for as treasury stock. Payroll taxes on restricted stock and stock options are reflected in financing activities in our consolidated statement of cash flows.

Note 14 Income Taxes

Our effective tax rate was 33 percent in second quarter 2008 and first six months 2008 and 37 percent in second quarter 2007 and first six months 2007. We anticipate that our effective tax rate in 2008 will be about 34 percent.

The 2008 rate reflects a one-time tax benefit for the adjustment of deferred taxes resulting primarily from a federal income tax rate change for qualified timber gains due to the Heartland, Habitat, Harvest and Horticulture Act of 2008.

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Item 2. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

Management s Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the financial statements and Management s Discussion and Analysis of Financial Condition and Results of Operations in our 2007 Annual Report on Form 10-K.

Forward-Looking Statements

This Quarterly Report on Form 10-Q and other materials we have filed or may file with the Securities and Exchange Commission contain forward-looking statements within the meaning of the federal securities laws. These forward-looking statements are identified by their use of terms and phrases such as believe, anticipate, could, estimat likely, intend, may, plan, expect, and similar expressions, including references to assumptions. These statements reflect our current views with respect to future events and are subject to risk and uncertainties. We note that a variety of factors and uncertainties could cause our actual results to differ significantly from the results discussed in the forward-looking statements. Factors and uncertainties that might cause such differences include, but are not limited to:

general economic, market or business conditions;

the opportunities (or lack thereof) that may be presented to us and that we may pursue;

future residential or commercial entitlements;

expected development timetables and projected timing for sales of lots or other parcels of land;

development approvals and the ability to obtain such approvals;

the anticipated price ranges of lots in our developments;

the number, price and timing of land sales or acquisitions;

estimated land holdings for a particular use within a specified time frame;

absorption rates and expected gains on land and lot sales;

the levels of resale inventory in our development projects and the regions in which they are located;

the development of relationships with strategic partners;

the pace at which we release lots for sale;

fluctuations in costs and expenses;

demand for new housing, which can be affected by the availability of mortgage credit;

government energy policies;

demand for oil and gas;

competitive actions by other companies;

changes in laws or regulations and actions or restrictions of regulatory agencies;

the results of financing efforts, including our ability to obtain financing with favorable terms;

- the ability to complete merger, acquisition or divestiture plans; regulatory or other limitations imposed as a result of a merger, acquisition or divestiture; and the success of the business following a merger, acquisition or divestiture; and

- the final resolutions or outcomes with respect to our contingent and other corporate liabilities related to our business.

Other factors, including the risk factors described in Item 1A of our 2007 Annual Report on Form 10-K, may also cause actual results to differ materially from those projected by our forward-looking statements. New factors emerge from time to time and it is not possible for us to predict all such factors, nor can we assess the impact of any such factor on our business or the extent to which any factor, or combination of factors, may cause results to differ materially from those contained in any forward-looking statement.

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Any forward-looking statement speaks only as of the date on which such statement is made, and, except as required by law, we expressly disclaim any obligation or undertaking to disseminate any updates or revisions to any forward-looking statement to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events.

Introduction

In first quarter 2008, we changed our reportable segments to reflect our post-spin management of the operations transferred to us from Temple-Inland. All prior period segment information has been reclassified to conform to the current presentation. We manage our operations through three business segments:

- Real estate,
- Mineral resources, and
- Fiber resources.

Our strategy is to maximize and grow long-term stockholder value through:

- entitlement and development of real estate;
- realization of value from natural resources; and
- accelerated growth through strategic and disciplined investment in real estate.

Unless otherwise indicated, information is presented as of June 30, 2008, and references to acreage owned include all acres owned by ventures regardless of our ownership interest in a venture.

Our operations are affected to varying degrees by supply and demand factors and economic conditions including availability of mortgage credit; changes in interest rates; new housing starts; real estate values; employment levels; market prices for oil, gas and timber; and the overall strength of the U.S. economy.

Critical Accounting Policies and Estimates

There have been no significant changes in our critical accounting policies or estimates in first six months 2008 from those disclosed in our 2007 Annual Report on Form 10-K.

Recent Accounting Standards

Please read Note 3 to the Consolidated Financial Statements contained in this Quarterly Report on Form 10-Q.

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Results of Operations

Net income was $9,596,000, or $0.27 per diluted share, in second quarter 2008, compared with $14,432,000, or $0.41 per diluted share, for second quarter 2007. Net income for first six months 2008 was $9,358,000, or $0.26 per diluted share, compared with $15,093,000 or $0.43 per diluted share, for first six months 2007.

Current conditions in the residential development industry are difficult due to an oversupply of housing, declining sales volume for existing and new homes, flat to declining sales prices and a significant tightening of mortgage credit. A decline in consumer confidence is also evident. All geographic markets and products have not been affected to the same extent or with equal severity, but most have experienced declines. It is likely these conditions will continue throughout 2008.

Market conditions in the oil and gas industry are strong, with continued long-term growth in demand for oil and gas expected. As a result, oil and gas prices are at near record levels.

A summary of our consolidated results follows:

	Second Quarter		First Six Months	
	2008	2007	2008	2007
	(In thousands)			
Revenues:				
Real estate	$ 24,118	$ 47,317	$ 52,561	$ 74,883
Mineral resources	24,386	5,186	30,654	9,040
Fiber resources	3,093	3,782	5,605	6,818
Total revenues	$ 51,597	$ 56,285	$ 88,820	$ 90,741
Segment earnings:				
Real estate	$ 874	$ 23,040	$ 4,417	$ 26,776
Mineral resources	23,247	4,693	29,752	8,072
Fiber resources	1,411	2,353	4,251	2,698
Total segment earnings	25,532	30,086	38,420	37,546
Items not allocated to segments:				
General and administrative	(5,348)			