

Meritage Homes CORP
Form 10-K/A
November 01, 2006

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

Amendment No. 1

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

For the fiscal year ended December 31, 2005

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934**
Commission File Number 1-9977

(Exact Name of Registrant as Specified in its Charter)

Maryland

(State or Other Jurisdiction of Incorporation or Organization)

86-0611231

(IRS Employer Identification No.)

17851 North 85th Street, Suite 300 Scottsdale, Arizona

(Address of Principal Executive Offices)

85255

(Zip Code)

(480) 609-3330

(Registrant's telephone number, including area code)

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

Common Stock, \$.01 par value

New York Stock Exchange

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

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Yes No

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

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

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 Accelerated Filer Non-accelerated filer

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

The aggregate market value of common stock held by non-affiliates of the registrant (23,388,408 shares) as of June 30, 2005, was \$1,859,378,436, based on the closing sales price per share as reported by the New York Stock Exchange on such date.

The number of shares outstanding of the registrant's common stock on October 30, 2006 was 26,121,016.

DOCUMENTS INCORPORATED BY REFERENCE

Portions from the registrant's Proxy Statement relating to the Annual Meeting of Stockholders held on May 17, 2006 have been incorporated by reference into Part III, Items 10, 11, 12 and 13.

MERITAGE HOMES CORPORATION
FORM 10-K/A FOR THE FISCAL YEAR ENDED DECEMBER 31, 2005

Explanatory Note

This annual report on Form 10-K/A is filed for the purpose of restating Note 13 in the Notes to Consolidated Financial Statements for the years ended December 31, 2005, 2004 and 2003, which includes expanded reportable segment footnote disclosure related to our homebuilding operations. The restatement has no impact on our consolidated balance sheets as of December 31, 2005 and 2004, or our consolidated statements of earnings and related earnings per share amounts, consolidated statements of cash flows or consolidated statements of stockholders equity for the years ended December 31, 2005, 2004 and 2003. Conforming changes have been made to the Business section in Item 1, Management's Discussion and Analysis of Financial Condition and Results of Operations in Item 7 and our Controls and Procedures discussion in Item 9A of this Form 10-K/A. See Note 13 in the Notes of Consolidated Financial Statements for further information relating to the restatement. This Form 10-K/A has not been updated for events or information subsequent to the date of filing of the original Form 10-K, except in connection with the foregoing.

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FORM 10-K/A
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PART I

Item 1. Business

The Company

Meritage Homes is a leading designer and builder of single-family attached and detached homes in the fast-growing southern and western United States, based on the number of home closings. We offer a variety of homes that are designed to appeal to a wide range of homebuyers, including first-time, move-up, luxury and active adult buyers. We have operations in three regions: West, Central and East, which are comprised of 14 metropolitan areas in six states. These three regions are our principal business segments.

Our homebuilding and marketing activities are conducted under the name of Meritage Homes in each of our markets, except for certain communities in Arizona, where we operate under the name of Monterey Homes, in Texas, where we operate in certain communities as Legacy Homes and Monterey Homes and in certain communities in Florida, where we operate as Greater Homes. At December 31, 2005, we were actively selling homes in 184 communities, with base prices ranging from approximately \$109,000 to \$1,147,000.

Available Information; Corporate Governance

Meritage Homes Corporation was incorporated in 1988 as a real estate investment trust in the State of Maryland. In 1996 and 1997, through a merger and acquisition, we acquired the homebuilding operations of our predecessor companies having operations in Arizona and Texas. We currently focus exclusively on homebuilding and related activities and no longer operate as a real estate investment trust.

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

Meritage operates within a comprehensive plan of corporate governance for the purpose of defining responsibilities and setting high standards for ethical conduct. Our Board of Directors has established an audit committee, executive compensation committee and nominating/governance committee. The charter of each of these committees is available on our website. In addition, we have made available on our website our Code of Ethics and our Corporate Governance Principles and Practices. Our committee charters, Code of Ethics and Corporate Governance Principles and Practices are also available in print, free of charge, to any stockholder who requests any of them by calling us or by writing to us at our principal executive offices in Arizona at the following address: Meritage Homes Corporation, 17851 North 85th Street, Suite 300, Scottsdale, Arizona 85255, Attention: Legal Department. Our telephone number is (480) 609-3330.

Competitive Strengths

We believe Meritage possesses the following competitive strengths:

Conservative inventory management. We seek to minimize land and inventory risk in order to optimize our use of capital and maintain moderate leverage ratios. We accomplish this by:

- generally purchasing land after full entitlements have been obtained, including zoning and utility services;
- developing smaller parcels, which generally consist of projects that can be completed within a three-year period;
- controlling a significant portion of our land inventory through rolling options and land purchase contracts with initial deposit requirements typically between 1% and 15% of the land price;
- managing housing inventory by pre-selling and obtaining customer deposits on a significant majority of our homes prior to starting construction;

- limiting construction starts on unsold homes; and
- minimizing home construction cycles.

Disciplined financial management. We believe that our disciplined financial management policies enable us to achieve above-average returns on assets compared to our competitors in the homebuilding industry and to maintain reasonable leverage ratios. Our rigorous investment requirements for our new communities, whether developed internally or acquired, enable us to deploy capital efficiently and to generate strong cash flows to fund the acquisition of additional land or homebuilding operations.

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Strong margins. We believe that our focus on achieving good margins results in greater profitability during strong economic periods and also enables us to realize lower break-even points to provide greater pricing flexibility during slower economic periods. In addition to maintaining low overhead costs, we actively manage construction costs and pricing and marketing strategies in order to maximize margins. We seek to optimize our mix of available housing upgrades and customization features to offer the highest value to customers at the lowest cost. Within our pricing structure we provide our sales and marketing professionals with the autonomy and flexibility to respond rapidly to changing market dynamics by customizing our sales programs and customer incentives.

Experienced management team with significant equity ownership. Members of our senior management team have extensive experience in the homebuilding industry as well as in-depth knowledge of the local markets that we serve. Our co-chief executive officers and senior executives have extensive homebuilding experience and each has delivered successful results through varying homebuilding cycles. At March 1, 2006, our co-chief executive officers together beneficially owned approximately 15% of our outstanding common stock.

Product breadth and geographic diversity. We believe that our product breadth and geographic diversity enhance our growth potential and help to reduce exposure to any specific economic cycle. We tailor our product offerings to local markets and changing demographics and customer preferences. In all of our markets we typically focus on the first and second-time move up markets. We also offer niche products in certain markets. For example, in Arizona, Texas and California we build within the luxury market; in California and Florida we build within the multi-story condo market; in Arizona we build within the active adult market and in Arizona, Texas and Reno, Nevada we build within the first-time market.

Business Strategies

We seek to distinguish ourselves from other production homebuilders through the following business strategies:

Focus on high growth markets. Our operations are located in six rapidly growing western and southern states: Texas, Arizona, California, Nevada, Colorado and Florida. These areas are generally characterized by high job and population growth trends, creating strong demand for new housing, and we believe these to be attractive homebuilding markets with opportunities for long-term growth. Our operations in Texas, Arizona, California and Nevada are well established and we believe that we have developed a reputation for building distinctive quality homes within these markets.

Expand into new and within existing markets. We continuously evaluate expansion opportunities through strategic acquisitions of other homebuilders and internal growth through expansion of our product offering in existing markets or start-up operations in new geographic areas. In pursuing expansion, we explore markets with demographic and other growth characteristics similar to our current markets and seek to acquire entities with operating policies and earnings-focused philosophies similar to ours. Within the last two years, we began start-up operations in Denver, Colorado, Orlando, Florida and Reno, Nevada, and acquired operations in Ft. Myers/Naples and Orlando, Florida, which we believe are geographic markets that possess excellent demographic and growth characteristics.

In the past eight years we have successfully completed eight acquisitions, enabling us to substantially increase our revenue and earnings, expand our geographic footprint, increase our share of existing markets and develop new product lines, such as active adult housing for the Arizona retirement market and condominiums in certain markets.

Maintain low cost structure. Throughout our history, we have focused on minimizing construction costs and overhead, which we believe are key factors in maintaining high margins and profitability. We reduce costs and overhead by:

- using subcontractors for home construction and site improvement on a fixed-price basis;

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- obtaining favorable pricing from subcontractors through long-term relationships and high volume;
- reducing interest and carrying costs by minimizing our inventory of unsold homes and minimizing the home construction cycle;
- delaying construction on a home until it is under contract, we have received a substantial earnest money deposit and the buyer has obtained preliminary approval for a mortgage loan;
- centralizing certain administrative activities; and
- monitoring homebuilding production, scheduling and budgeting through management information systems.

Superior design, quality and customer service. We seek to maximize customer satisfaction by offering homes that are built with quality materials and craftsmanship, exhibit distinctive design features and are situated in premium locations. We believe that we generally offer higher caliber homes in their defined price range or category compared to those built by our competitors. In addition, we seek to achieve the highest level of customer satisfaction as an integral part of our competitive strategy. For example, as part of the sales process, our experienced sales personnel continually inform customers

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of their home's construction progress, and after delivery, our customer care departments respond to homebuyers' questions and warranty matters.

Markets and Products

We currently build and sell homes in the following markets:

| Markets | Year Entered |
|---------------------------------|--------------|
| Phoenix, AZ | 1985 |
| Dallas/Fort Worth, TX | 1987 |
| Austin, TX | 1994 |
| Tucson, AZ | 1995 |
| Houston, TX | 1997 |
| San Francisco Bay Area, CA | 1998 |
| Sacramento, CA | 1998 |
| Las Vegas, NV | 2002 |
| San Antonio, TX | 2003 |
| Los Angeles (Inland Empire), CA | 2004 |
| Denver, CO | 2004 |
| Orlando, FL | 2004 |
| Reno, NV | 2005 |
| Ft. Myers/Naples, FL | 2005 |

The chart above reflects the dates our predecessor companies entered our Texas and Arizona markets.

Our homes range from entry level to semi-custom luxury, with base prices ranging from approximately \$109,000 to \$1,147,000. A summary of activity by state as of and for the year ended December 31, 2005, follows (dollars in thousands):

| | Year Ended December 31, 2005 | | Homes in Backlog | At December 31, 2005 | | |
|-----------------------|------------------------------|--------------------------|------------------------|------------------------|------------------------------|-------------------------------|
| | # of Homes Closed | Avg. Closing Price | | \$ Value of Backlog | Home Sites Controlled (1) | # of Active Communities |
| West Region | | | | | | |
| California | 1,627 | \$ 582.2 | 714 | \$ 420,964 | 8,285 | 20 |
| Nevada | 541 | 373.2 | 349 | 126,400 | 3,356 | 6 |
| West Region Total | 2,168 | 530.0 | 1,063 | 547,364 | 11,641 | 26 |
| Central Region | | | | | | |
| Arizona | 3,122 | 279.7 | 2,427 | 838,702 | 16,425 | 35 |
| Texas | 3,576 | 220.1 | 2,173 | 509,465 | 15,667 | 108 |
| Colorado | 8 | 351.1 | 32 | 11,822 | 1,027 | 3 |
| Central Region Total | 6,706 | 248.0 | 4,632 | 1,359,989 | 33,119 | 146 |
| East Region | | | | | | |
| Florida | 532 | 347.1 | 699 | 274,247 | 9,349 | 12 |
| Total Company | 9,406 | \$ 318.6 | 6,394 | \$ 2,181,600 | 54,109 | 184 |

(1) Home Sites Controlled is the estimated number of homes that could be built on lots controlled by the Company, both on lots available for sale and on land expected to be developed into lots.

Land Acquisition and Development

We typically acquire land only after necessary entitlements have been obtained so that development or construction may begin as market conditions dictate. The term "entitlements" refers to development agreements, tentative maps or recorded plats, depending on the jurisdiction within which the land is located. Entitlements generally give the developer the right to obtain building permits upon compliance with conditions that are ordinarily within the developer's control. Even though entitlements are usually obtained before land is purchased, we are still required to

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secure a variety of other governmental approvals and permits during development. The process of obtaining such approvals and permits can substantially delay the development process. We may consider, on a limited basis, purchasing unentitled property when we can do so in a manner consistent with our business strategy. Although historically we have generally developed parcels ranging from 100 to 300 lots, in order to achieve and maintain an adequate inventory of lots, we are beginning to purchase larger parcels, in many cases with joint venture partners. In some cases, these joint ventures purchase undeveloped land and develop the land themselves.

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We select land for development based upon a variety of factors, including:

- demographic factors, based on extensive internal and external marketing studies;
- suitability for development generally within a one to four-year time period from the beginning of the development process to the delivery of the last home;
- financial feasibility of the proposed project, including projected profit margins, returns on capital employed, and the capital payback period;
- the ability to secure governmental approvals and entitlements;
- results of environmental and legal due diligence;
- proximity to local traffic corridors and amenities; and
- management's judgment as to the real estate market and economic trends, and our experience in particular markets.

We acquire land through options and land purchase contracts. Purchases are generally financed through our revolving credit facility or working capital. Acquiring our land through option contracts allows us to control lots and land through third parties who own or buy properties on which we plan to build homes. We enter into option contracts to purchase finished lots at a certain price during a specified period of time from these third parties as home construction begins. These contracts are generally non-recourse and typically require the payment of non-refundable deposits of 1% to 15% of the sales price. At December 31, 2005, we had approximately \$167.5 million in cash deposits and \$81.5 million in letters of credit deposits on real estate under option or contract. The total value of land under option or contract at that time was approximately \$2.8 billion. Additional information relating to our lots and land under option is presented in Note 3 – Variable Interest Entities and Consolidated Real Estate Not Owned, in the accompanying consolidated financial statements.

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

We develop a design and marketing concept tailored to each community, which includes the determination of size, style and price range of homes. We also determine street layout, individual lot size and layout, and overall community design for these projects. The product lines offered depend upon many factors, including the housing generally available in the area, the needs of a particular market, and our lot costs for the project; though we are sometimes able to use standardized design plans for a product line.

The following table presents information as of December 31, 2005 (dollars in thousands):

| | Lots Owned (1) | Lots Under Contract or Option (1)(2) | Total Lots Controlled |
|-----------------------|----------------|---|--------------------------|
| West Region | | | |
| California | 333 | 7,952 | 8,285 |
| Nevada | 280 | 3,076 | 3,356 |
| West Region Total | 613 | 11,028 | 11,641 |
| Central Region | | | |
| Arizona | 995 | 15,430 | 16,425 |
| Texas | 3,022 | 12,645 | 15,667 |
| Colorado | 41 | 986 | 1,027 |
| Central Region Total | 4,058 | 29,061 | 33,119 |
| East Region | | | |
| Florida | 230 | 9,119 | 9,349 |

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| | | | |
|----------------------------|------------|------------|------------|
| Total Company | 4,901 | 49,208 | 54,109 |
| Total book cost (3) | \$ 370,921 | \$ 166,964 | \$ 537,885 |

-
- (1) Excludes lots with finished homes or homes under construction. The number of lots is estimated and is subject to change.
- (2) There can be no assurance that we will actually acquire any lots under option or properties in which we have entered into a variety of contractual relationships, including purchase agreements with customary conditions precedent and other similar arrangements. These amounts do not include 9,098 lots under contract with refundable earnest money deposits of approximately \$0.6 million for which we have not completed due diligence and, accordingly, have no money at risk and are under no obligation to perform under the contract, but include 4,673 lots under option contracts with joint ventures in which we are a member.
- (3) For Lots Owned, book cost primarily represents land, development, interest and common costs. For Lots under Contract or Option, book cost primarily represents earnest deposits and option deposits.

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Construction Operations

We act as the general contractor for our projects and typically hire subcontractors on a project-by-project or reasonable geographic-proximity basis to complete construction at a fixed price. We usually enter into agreements with subcontractors and materials suppliers on an individual basis after receiving competitive bids, when appropriate. We obtain information from prospective subcontractors and suppliers with respect to their financial condition and ability to perform their agreements before formal bidding begins. Occasionally, we enter into longer-term contracts with subcontractors and suppliers if we can obtain more favorable terms to minimize costs of construction. Our project managers and field superintendents coordinate and supervise the activities of subcontractors and suppliers, subject the development and construction work to quality and cost controls, and monitor compliance with zoning and building codes. At December 31, 2005, we employed approximately 950 construction operations personnel.

We specify that quality, durable materials be used in construction of our homes and we do not maintain significant inventories of construction materials, except for work in process materials for homes under construction. When possible, we negotiate price and volume discounts with manufacturers and suppliers on behalf of our subcontractors to take advantage of production volume. Historically, access to our principal subcontracting trades, materials and supplies has been readily available in each of our markets. Prices for these goods and services may fluctuate due to various factors, including supply and demand shortages that may be beyond the control of our vendors. We believe that we have good relationships with our suppliers and subcontractors.

We generally build and sell homes in clusters or phases within our larger projects, which we believe creates efficiencies in land development and construction, and improves customer satisfaction by reducing the number of vacant lots surrounding a completed home. Our homes are typically completed within four to nine months from the start of construction, depending upon the geographic location and the home size and complexity. Construction schedules may vary depending on the availability of labor, materials and supplies, product type, location and weather. Our homes are usually designed to promote efficient use of space and materials, and to minimize construction costs and time. We typically have not entered into any derivative contracts to hedge against weather or materials fluctuations as we do not believe they are particularly advantageous to our operations.

Marketing and Sales

We believe that we have an established reputation for developing high quality homes, which helps generate interest in each new project. We also use advertising and other promotional activities, including our website at www.meritagehomes.com, magazine and newspaper advertisements, brochures, direct mailings and the placement of strategically located signs in the vicinities around our developments.

We use furnished model homes as tools in demonstrating to prospective homebuyers the advantages of our home designs and various features. We generally employ or contract with interior and landscape designers who are responsible for creating an attractive model home with many built-in options for each product line within a project. We generally build between one and four model homes for each actively selling community, depending upon the number of homes to be built in the project and the products to be offered. Often, we lease our model homes from institutional investors who own the homes for investment purposes or from individual buyers who do not intend to occupy the home immediately. At December 31, 2005, we owned or leased 353 model homes, with an additional 95 models under construction. Total monthly payments for these models are approximately \$505,000, of which approximately \$216,000 is accounted for as interest on debt related to our model lease program.

Our homes generally are sold by full-time, commissioned employees who typically work from a sales office located in one of the model homes for each project. At December 31, 2005, we had 370 sales and marketing personnel. Our goal is to ensure that our sales force has extensive knowledge of our operating policies and housing products. To achieve this goal, we train our sales associates and conduct periodic meetings to update them on sales techniques, competitive products in the area, financing availability, construction schedules, marketing and advertising plans and the available product lines, pricing, options and warranties offered. Our sales associates are licensed real estate agents where required by law. Independent brokers also sell our homes, and are usually paid a sales commission based on the price of the home. Our sales associates assist our customers in selecting upgrades or in adding available customization features to their homes, which we design to appeal to local consumer demands. Occasionally we offer various sales incentives, such as landscaping or interior upgrades, to attract buyers. The use and type of incentives depends largely on economic and local competitive market conditions.

Backlog

Most of our home sales are made under standard sales contracts signed before construction of the home begins. The contracts require cash deposits and are usually subject to certain contingencies such as the buyer's ability to qualify for financing. Homes covered by such sales contracts but not yet closed are considered backlog. Sales contingent upon the

sale of a customer's existing home are not included as new sales contracts until the contingency is removed. We do not recognize revenue upon the sale of a home until it is delivered to the homebuyer and other criteria for sale and profit recognition are met. We sometimes build homes before obtaining a sales contract; however, these homes are excluded from backlog until a sales contract is signed. At December 31, 2005, of our homes in inventory, 11% were under construction without sales contracts and 3% were completed homes without sales contracts. We believe that we will deliver substantially all homes in backlog at December 31, 2005 to customers during 2006.

Our backlog increased to 6,394 units with a value of approximately \$2.2 billion at December 31, 2005 from 4,408 units with a value of approximately \$1.3 billion at December 31, 2004. These increases are primarily due to additional communities that opened for sale in 2005, our 2005 acquisitions in Florida and strong new home orders in 2005.

Customer Financing

We attempt to help qualified homebuyers who require financing to obtain loans from mortgage lenders that offer a variety of financing options. We provide mortgage-broker services in most of our markets through relationships with mortgage-brokers, generally through joint ventures in which we have a non-controlling interest, which facilitate obtaining customer loans on behalf of third party lenders. In some markets we use unaffiliated preferred mortgage lenders. We may pay a portion of the closing costs and discount mortgage points to assist homebuyers with financing. We do not fund or service the mortgages obtained by our homebuyers, and therefore do not assume the risks associated with a mortgage banking business. Since many customers use long-term mortgage financing to purchase homes, adverse economic conditions, rising mortgage interest rates and increases in unemployment may deter or reduce the number of potential homebuyers.

Customer Relations, Quality Control and Warranty Programs

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

A Meritage project manager or project superintendent and a customer relations representative generally oversee compliance with quality control standards for each community. These representatives perform the following tasks:

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

We generally provide for each home a one- to two-year limited warranty on workmanship and building materials and a two- to ten-year structural warranty, which may be provided by a third party insurer. We generally require our subcontractors to provide an indemnity and a certificate of insurance before beginning work, which means that claims relating to workmanship and materials are generally the subcontractors responsibility. Reserves for future warranty costs are established based on historical experience within each division or region, and are recorded when the homes are closed. Reserves generally range from .30% to .78% of a home's sale price. Historically, these reserves have been sufficient to cover warranty repairs.

Competition and Market Factors

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

- experience within our geographic markets which allows us to develop and offer new products;

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- ability to recognize and adapt to changing market conditions, including from a capital and human resource perspective;
- ability to capitalize on opportunities to acquire land on favorable terms; and
- reputation for outstanding service and quality products.

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Government Regulation and Environmental Matters

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

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

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

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

Employees and Subcontractors

At December 31, 2005, we had approximately 1,810 full-time employees, including 490 in management and administration, 370 in sales and marketing, and 950 in construction operations. Our employees are not unionized, and we believe that we have good employee relationships. We pay for a substantial portion of the insurance costs, with the balance contributed by the employees. We also have a 401(k) savings plan, which is available to most of our employees.

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

Investments in Unconsolidated Entities

We participate in numerous joint ventures with independent third parties (approximately 20 joint ventures at December 31, 2005) relating to the purchase and development of land. We have less than a controlling interest in these types of entities. We typically enter into these joint ventures with other homebuilders to provide the joint venture partners with a means of accessing larger parcels and lot positions. The typical joint venture acquires raw land and processes the property through the entitlement stage and, in some cases, develops the property into partially or fully finished lots. These joint ventures are usually obligated to sell all or a part of the property or lots to the joint venture members (at the respective member's option), generally at prevailing fair market values (either at the time of acquisition or the time of sale). In some cases, part of the property is sold to non-member homebuilders, commercial developers and other third parties. Our participation in these types of joint ventures, which is an increasingly important part of our business model, has increased during the last couple of years and we expect it to continue to increase in the foreseeable future.

In connection with these types of joint ventures, we and/or joint venture partners provide certain types of repayment guarantees, indemnification arrangements with surety and performance bond providers and environmental indemnities. Reference is made to Part II, Item 7 in this Annual Report titled "Management's Discussion and Analysis of Financial Condition and Results of Operations - Off-Balance Sheet Arrangements" for a discussion of these items.

We also participate in joint ventures relating to the provision of mortgage brokerage and title services. The purpose

of these joint ventures is to establish relationships with providers of mortgage brokerage and title services in order to facilitate the design of products that can be offered to our customers at attractive prices in a convenient manner. We believe these types of joint ventures provide a valuable service to our customers and provide us with additional revenue and profit opportunities, although at the current time these types of arrangements are not a significant component of our business.

At December 31, 2005, we had approximately \$86.4 million invested in joint ventures involved in the purchase, development and/or sale of land. We also had approximately \$2.3 million invested in mortgage brokerage and title service joint ventures. In 2005, we reported pre-tax earnings of \$9.3 million related to our share of the earnings of our land joint ventures and \$9.0 million related to our share of the earnings of our mortgage-brokerage and title service joint ventures. For our land joint ventures, we do not recognize profits on lots or land that we acquire from the joint venture, but instead defer any profits until we sell the related homes to third party homebuyers.

Item 1A. Risk Factors

Our future operating results and financial condition depend on our ability to successfully design, develop, construct and sell homes that satisfy dynamic customer demand patterns. Inherent in this process are factors that we must successfully manage to achieve favorable future operating results and financial condition. These operating and financial factors, along with many other factors, could affect our business and the price of our common stock and notes. Potential risks and uncertainties that could affect our future operating results and financial condition include the following:

Interest Rates and Mortgage Financing. In general, housing demand is adversely affected by increases in interest rates and the unavailability of mortgage financing. Most of our buyers finance their home purchases through third-party lenders providing mortgage financing. If mortgage interest rates increase and, consequently, the ability of prospective buyers to finance home purchases is adversely affected, home sales, gross margins and cash flow may also be adversely affected and the impact may be material. Long-term interest rates currently remain at low levels; however, rates have increased in the last year from historically low levels and it is impossible to predict future increases or decreases in market interest rates.

Homebuilding activities depend upon the availability and costs of mortgage financing for buyers of homes owned by potential customers, as those customers (move-up buyers) often must sell their residences before they purchase our homes. Mortgage lenders have recently become subject to more intense underwriting standards by the regulatory authorities which oversee them. More stringent underwriting standards could indirectly have a material adverse effect on our business if certain buyers are unable to obtain mortgage financing.

Housing Affordability and Market Conditions. As a participant in the homebuilding industry, we are subject to market forces beyond our control. In general, housing demand is adversely affected by the affordability of housing. In recent periods, the affordability of housing has declined in many of our markets, which could adversely affect the ability of our customers, particularly first-time homebuyers, to afford our product offerings. In addition, many homebuyers need to sell their existing home in order to purchase a new home from us, and a weakening of the home sale market or a decrease or leveling in home sale prices could adversely affect that ability. Some commentators believe that the prices of homes are inflated and may decline if the demand for homes weakens. A decline in prices for homes could have an adverse effect on our homebuilding business.

Cancellations. Our backlog reflects the number and value of homes for which we have entered into a sales contract with a customer but have not yet delivered the home. Although these sales contracts typically require a cash deposit and do not make the sale contingent on the sale of the customer's existing home, in some cases a customer may cancel the contract and receive a complete or partial refund of the deposit as a result of local laws or as a matter of our business practices. If home prices begin to decline, interest rates increase or there is a national or local economic decline, homebuyers may have an incentive to cancel their contract with us, even where they might be entitled to no refund or only a partial refund. An increase in cancellations could have a material adverse effect on our business.

Future Expansion. We may continue to consider growth or expansion of our operations in our current markets or in other areas of the country. Our expansion into new or existing markets could have a material adverse effect on our cash flows or profitability. The magnitude, timing and nature of any future expansion will depend on a number of factors,

including suitable acquisition candidates, the negotiation of acceptable terms, our financial capabilities and general economic and business conditions. New acquisitions may result in the incurrence of additional debt. Acquisitions also involve numerous risks, including difficulties in the assimilation of the acquired company's operations, the incurrence of unanticipated liabilities or expenses, the diversion of management's attention from other business concerns, risks of entering markets in which we have limited or no direct experience and the potential loss of key employees of the acquired company.

Dependence on Subcontractors. We conduct our construction operations only as a general contractor. Virtually all architectural, construction and development work is performed by unaffiliated third-party subcontractors. As a consequence, we depend on the continued availability of and satisfactory performance by these subcontractors for the design and

construction of our homes. We cannot assure you that there will be sufficient availability of and satisfactory performance by these unaffiliated third-party subcontractors. In addition, inadequate subcontractor resources could have a material adverse affect on our business.

Operating and Financial Limitations. The indentures for our senior notes and the agreement for our senior unsecured credit facility impose significant operating and financial restrictions on us. These restrictions limit our ability and the ability of our subsidiaries, among other things, to:

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

In addition, the indentures for our senior notes and the agreement for our senior unsecured credit facility require us to maintain a minimum consolidated tangible net worth and our credit facility requires us to maintain other specified financial ratios, including the amount and types of land, speculative housing and model homes that we may own at any given time. We cannot assure you that these covenants will not adversely affect our ability to finance our future operations or capital needs or to pursue available business opportunities. A breach of any of these covenants or our inability to maintain the required financial ratios could result in a default in respect of the related indebtedness. If a default occurs, the relevant lenders could elect to declare the indebtedness, together with accrued interest and other fees, to be immediately due and payable.

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

Our joint venture investments are generally very illiquid both because we lack a controlling interest in the ventures and because most of our joint ventures are structured to require super-majority or unanimous approval of the members to sell a substantial portion of the joint venture's assets or for a member to receive a return of their invested capital. Our lack of controlling interest also results in the risk that the joint venture will take actions that we disagree with, or fail to take actions that we desire.

Colonial Homes and Greater Homes Acquisitions. In February and September 2005, we completed the acquisitions of substantially all of the homebuilding operations of Colonial Homes of Ft. Myers/Naples, Florida, and Greater Homes of Orlando, Florida, respectively. The integration of Colonial and Greater Homes into our operations following the acquisitions will involve a number of risks. In particular, the combined companies may experience attrition among management and personnel. The integration process could also disrupt the activities of our current business. The integration of companies requires, among other things, coordination of management, administrative and other functions. Failure to overcome these challenges or any other problems encountered in connection with the acquisitions

of Colonial and Greater Homes could cause our financial condition, results of operations and competitive position to decline. Our integration of the Colonial Homes and Greater Homes acquisitions assumes certain synergies and other benefits. We cannot assure you that unforeseen factors will not offset the intended benefits of the acquisition in whole or in part.

Attached Product and Condominium Offerings. In connection with the acquisition of Colonial, we became involved in the construction and sale of multi-story condominium homes. Prior to this acquisition, our business has typically involved only the construction and sale of single-family homes. The construction and sale of condominium homes involves different construction processes and subcontractors and, to a degree, different customers. In addition, condominium homes typically involve more extensive sales and warranty regulations. Although we now employ most of the Colonial Homes employees that were involved with the Colonial business (including condominium construction and sales), we have little prior experience in the condominium business. In addition, we are expanding into condominium construction and sales in other markets in which we operate and we face similar challenges and risks with such endeavors.

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Dependence on Key Personnel. Our success largely depends on the continuing services of certain key employees, including our Co-Chief Executive Officers, John R. Landon and Steven J. Hilton, and our ability to attract and retain qualified personnel. We have employment agreements with Messrs. Landon and Hilton, but we do not have employment agreements with certain other key employees. We believe that Messrs. Landon and Hilton each possess valuable industry knowledge, experience and leadership abilities that would be difficult in the short term to replicate. In addition, Messrs. Landon and Hilton have cultivated key contacts and relationships with important participants in the land acquisition process in our various communities across the country. The loss of the services of key employees could harm our operations and business plans.

Limited Geographic Diversification. We have operations in Texas, Arizona, California, Nevada, Colorado and Florida. Our limited geographic diversification could adversely impact us if the homebuilding business in our current markets should decline, since there may not be a balancing opportunity in a stronger market in other geographic regions.

Increased Insurance Costs. Recently, lawsuits have been filed against builders asserting claims of personal injury and property damage caused by the presence of mold in residential dwellings. Some of these lawsuits have resulted in substantial monetary judgments or settlements. We believe that we have maintained adequate insurance coverage to insure against these types of claims for homes completed before October 1, 2003. Insurance carriers have been excluding from policies of many homebuilders coverage for claims arising from the presence of mold for many builders and, as of October 1, 2003, our insurance policy began excluding mold coverage. If our retentions are not sufficient to protect against these types of claims or if we are unable to obtain adequate insurance coverage, a material adverse effect on our business, financial condition and results of operations could result if we are exposed to claims arising from the presence of mold in the homes that we build.

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

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

Home Warranty Factors. Construction defect and home warranty claims are common in the homebuilding industry and can be costly. While we maintain product liability insurance and generally require our subcontractors and design professionals to indemnify us for liabilities arising from their work, we cannot assure you that these insurance rights and indemnities will be adequate to cover all construction defect and warranty claims for which we may be held liable. For example, we may be responsible for applicable self-insured retentions, which have increased recently, and certain claims may not be covered by insurance or may exceed applicable coverage limits.

Homebuilding Industry Factors. The homebuilding industry is cyclical and is significantly affected by changes in economic and other conditions such as employment levels, availability of financing, interest rates, and consumer confidence.

These factors can negatively affect demand for and cost of our homes. We are also subject to various risks, many of which are outside of our control, including delays in construction schedules, cost overruns, changes in governmental regulations (such as no- or slow-growth initiatives), increases in real estate taxes and other local government fees, and raw materials and labor costs.

We are also subject to the potential for significant variability and fluctuations in the cost and availability of real estate. Although historically we have generally developed parcels ranging from 100 to 300 lots, in order to achieve and maintain an adequate inventory of lots, we are beginning to purchase larger parcels, in many cases with a joint venture partner. Write-downs of our real estate could occur if market conditions deteriorate and these write-downs could be material in amount.

Fluctuations in Operating Results. We historically have experienced, and expect to continue to experience, variability in home sales and net earnings on a quarterly basis. As a result of such variability, our historical performance may

not be a meaningful indicator of future results. Factors that contribute to this variability include:

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

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

Additional Financing; Limitations. The homebuilding industry is capital intensive and requires significant up-front expenditures to secure land and begin development and construction. Accordingly, we incur substantial indebtedness to finance our homebuilding activities. At December 31, 2005, we had approximately \$592.1 million of indebtedness and other borrowings. If we require working capital greater than that provided by operations or available under our credit facility, we may be required to seek additional capital in the form of equity or debt financing from a variety of potential sources, including bank financing and securities offerings. There can be no assurance we would be able to obtain such additional capital on terms acceptable to us, if at all. The level of our indebtedness could have important consequences to our stockholders, including the following:

- our ability to obtain additional financing for working capital, capital expenditures, acquisitions or general corporate purposes may be impaired;
- we must use a substantial portion of our cash flow from operations to pay interest and principal on our indebtedness, which reduces the funds available to us for other purposes such as capital expenditures;
- we have a higher level of indebtedness than some of our competitors, which may put us at a competitive disadvantage and reduce our flexibility in planning for, or responding to, changing conditions in our industry, including increased competition; and
- we may be more vulnerable to economic downturns and adverse developments in our business than some of our competitors.

We expect to obtain the money to pay our expenses and to pay the principal and interest on our indebtedness from cash flow from operations. Our ability to meet our expenses thus depends on our future performance, which will be affected by financial, business, economic and other factors. We will not be able to control many of these factors, such as economic conditions in the markets where we operate and pressure from competitors.

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We cannot be certain that our cash flow will be sufficient to allow us to pay principal and interest on our debt and meet our other obligations. If we do not have sufficient funds, we may be required to refinance all or part of our existing debt, sell assets or borrow additional funds. We cannot guarantee that we will be able to do so on terms acceptable to us, if at all. In addition, the terms of existing or future debt agreements may restrict us from pursuing any of these alternatives.

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

We are also subject to a variety of local, state and federal statutes, ordinances, rules and regulations concerning the

protection of health and the environment. Environmental laws or permit restrictions may result in project delays, may cause substantial compliance and other costs and may prohibit or severely restrict development in certain environmentally sensitive regions or geographic areas. Environmental regulations can also have an adverse impact on the availability and price of certain raw materials, such as lumber.

Acts of War. Acts of war or any outbreak or escalation of hostilities between the United States and any foreign power, including the conflict with Iraq, may cause disruption to the economy, our company, our employees and our customers, which could impact our revenue, costs and expenses and financial condition.

Special Note of Caution Regarding Forward-Looking Statements

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

The words believe, expect, anticipate, forecast, plan, estimate, and project and similar expressions identify forward-looking statements speak only as of the date the statement was made. All statements we make other than statements of historical fact are forward-looking statements within the meaning of that term in Section 27A of the Securities Act of 1933, and Section 21E of the Exchange Act. Forward-looking statements in this Annual Report include statements concerning the demand for and the pricing of our homes, the growth potential of the markets we operate in, our acquisition strategy, demographic and other trends related to the homebuilding industry in general and our ability to capitalize on them, the future supply of housing inventory in our markets and the homebuilding industry in general, our ability to renew existing leases on comparable terms, our expectation that existing letters of credit and performance and surety bonds will not be drawn on, the adequacy of our insurance coverage and warranty reserves, our ability to deliver existing backlog, the expected outcome of legal proceedings against us, the sufficiency of our capital resources to support our growth strategy, our ability and willingness to acquire land under option or contract, the future impact of deferred tax assets or liabilities, the expectation of continued positive operating results in 2006 and beyond (including, but not limited to, that we will be able to achieve strong margins in the near term, that price appreciation will moderate and that we expect closings in our Florida market to increase in 2006) and the expected benefits of our acquisitions. Such statements are subject to significant risks and uncertainties.

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

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

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Our corporate offices are leased properties located in Scottsdale, Arizona, and Plano, Texas. The leases expire in March 2014 and April 2011, respectively. Our Dallas/Ft. Worth division occupies a building that is leased from a company owned beneficially by one of our co-chairmen. The lease expired in May 2005 and has continued on a month-to-month basis since that time. See Note 12 in the accompanying consolidated financial statements for further discussion of related party transactions.

We lease an aggregate of approximately 334,000 square feet of office space in our markets for our operating divisions and corporate and executive offices.

Item 3. Legal Proceedings

From time to time, the United States Environmental Protection Agency and Maricopa County (Arizona) Air Quality Department have assessed fines against us for violating dust control regulations. While we strive to maintain practices that comply with such regulations, dust control violations are common to the residential homebuilding industry in desert regions such as Arizona. We do not believe that such fines will have a material adverse effect on our business, financial position or results of operations.

Beginning in late 2003, we established relationships with title insurance companies in three states where we do business, under which one of our subsidiaries received a portion of the fees and premiums on title insurance purchased by certain of our homebuyers and reinsured a portion of the policy risk. The United States Department of Housing and Urban Development and certain state insurance regulators are investigating these types of arrangements. In 2004, we terminated those arrangements that were not expressly approved by a state regulator. In total, these arrangements contributed approximately \$600,000 to our fiscal 2004 pre-tax earnings. Although we believe our arrangements were structured and operated in compliance with applicable state and federal laws and regulations, the ultimate resolution of these investigations could result in fines and/or a disgorgement of profits.

We are involved in various routine legal proceedings incidental to our business, some of which are covered by insurance. With respect to the majority of pending litigation matters, our ultimate legal and financial responsibility, if any, cannot be estimated with certainty and, in most cases, any potential losses related to these matters are not considered probable. At December 31, 2005, we had approximately \$3.2 million in accrued legal expenses and settlement costs reserved for losses related to litigation and asserted claims where our ultimate exposure is considered probable and the potential loss can be reasonably estimated. Most of these matters relate to correction of home construction defects, foundation issues and general customer claims. We believe that none of these matters will have a material adverse impact upon our consolidated financial condition, results of operations or cash flows.

Item 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of security holders during the quarter ended December 31, 2005.

Executive Officers of the Registrant

The executive officers of the Company are elected each year at a meeting of the Board of Directors, which follows the annual meeting of the stockholders, and at other Board of Directors meetings as appropriate.

The names, ages, positions and business experience of our executive officers are listed below (all ages are as of March 1, 2006). There are no understandings between any of our executive officers and any other person pursuant to which any executive officer was selected to his office.

| Name | Age | Position |
|-------------------|------------|---|
| Steven J. Hilton | 44 | Co-Chairman of the Board and Chief Executive Officer |
| John R. Landon | 48 | Co-Chairman of the Board and Chief Executive Officer |
| Larry W. Seay | 50 | Chief Financial Officer and Executive Vice President |
| C. Timothy White | 45 | General Counsel, Executive Vice President and Secretary |
| Richard T. Morgan | 50 | Vice President and Treasurer |

Steven J. Hilton co-founded Monterey Homes in 1985, which merged with the Company's predecessor in December 1996. Mr. Hilton has been Co-Chairman and CEO since July 1997.

John R. Landon founded Legacy Homes in 1987, which combined with the Company in July 1997. Mr. Landon has been Co-Chairman and CEO since July 1997.

Larry W. Seay has been Chief Financial Officer since December 1996 and was appointed Executive Vice President in October 2005. Mr. Seay served as Secretary from 1997 to October 2005.

Richard T. Morgan has been Vice President since April 1998 and was appointed the Company's Treasurer in 2002.

C. Timothy White has been General Counsel, Executive Vice President and Secretary since October 2005 and served on the Meritage Board of Directors from December 1997 until October 2005.

PART II

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

Our common stock is listed on the New York Stock Exchange (NYSE) under the symbol MTH . The high and low sales prices per share of our common stock for the periods indicated, as reported by the NYSE, follow. Prices reflect a 2-for-1 stock split effected in the form of a stock dividend that occurred in January 2005:

| Quarter Ended | 2005 High | Low | 2004 High | Low |
|---------------|--------------|----------|--------------|----------|
| March 31 | \$ 76.62 | \$ 53.42 | \$ 39.83 | \$ 29.56 |
| June 30 | \$ 85.00 | \$ 58.54 | \$ 37.35 | \$ 29.46 |
| September 30 | \$ 96.50 | \$ 72.06 | \$ 39.81 | \$ 29.54 |
| December 31 | \$ 78.27 | \$ 57.29 | \$ 57.17 | \$ 35.80 |

On March 6, 2006, the closing sales price of the common stock as reported by the NYSE was \$56.01 per share. At that date, there were approximately 230 owners of record and approximately 5,700 beneficial owners of common stock.

The transfer agent for our common stock is Mellon Investor Services LLC, 85 Challenger Road, Ridgefield Park, NJ 07660 (www.melloninvestor.com).

We have not declared cash dividends for the past eight years, nor do we intend to declare cash dividends in the foreseeable future. We plan to retain the Company's earnings to finance the continuing development of the business. Future cash dividends, if any, will depend upon our financial condition, results of operations, capital requirements, compliance with certain restrictive debt covenants, as well as other factors considered relevant by our Board of Directors. Certain of our debt instruments contain restrictions on the payment of cash dividends. See Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources and Note 6 Senior Notes, in the accompanying consolidated financial statements.

Issuer Purchases of Equity Securities:

The following table summarizes our purchases of our own equity securities during the three months ended December 31, 2005:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans of Programs | Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs |
|-----------------------|---|---------------------------------------|---|---|
| October 1 - 31, 2005 | | | | \$ 50,000,000 |
| November 1 - 30, 2005 | 230,616 | \$ 62.47 | 230,616 | 35,593,446 |
| December 1 - 31, 2005 | | | | 35,593,446 |
| Total | 230,616 | \$ 62.47 | 230,616 | \$ 35,593,446 |

In August 2002, our Board of Directors authorized the expenditure of up to \$32 million to repurchase shares of our common stock. In January 2004, our Board of Directors approved an increase in this amount of \$26.8 million. During 2004, we completed the August 2002 stock repurchase program by repurchasing 1.1 million shares.

In August 2004, the Board of Directors approved a stock buyback program authorizing the expenditure of up to \$50 million to repurchase shares of our common stock. In 2005 we purchased 230,616 shares under this program at an average price of \$62.47. The program was completed in February 2006, with the repurchase of 601,000 shares at an average price of \$59.21.

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In February 2006, the Board of Directors approved a new stock repurchase program, authorizing the expenditure of up to \$100 million to repurchase shares of our common stock. There is no stated expiration date for this program. As of March 7, 2006, we had not repurchased any shares of our common stock under this program.

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Item 6. Selected Financial Data

The following table presents selected historical consolidated financial and operating data of Meritage Homes Corporation and subsidiaries as of and for each of the last five years ended December 31, 2005. The financial data has been derived from our consolidated financial statements and related notes for the periods presented, audited by our independent registered public accounting firms. This table should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and related notes included elsewhere in this Annual Report. These historical results may not be indicative of future results.

The data in the table includes the operations of Hancock Communities, Hammonds Homes, Perma-Bilt Homes, Citation Homes, Colonial Homes and Greater Homes since their dates of acquisition, May 2001, July 2002, October 2002, January 2004, February 2005 and September 2005, respectively.

| | Historical Consolidated Financial Data | | | | |
|--|--|--------------|--------------|--------------|-------------|
| | Years Ended December 31, | | | | |
| | (\$ in thousands, except per share amounts) | | | | |
| | 2005 | 2004 | 2003 | 2002 | 2001 |
| Statement of Earnings Data: | | | | | |
| Total closing revenue | \$ 3,001,102 | \$ 2,040,004 | \$ 1,471,001 | \$ 1,119,817 | \$ 744,174 |
| Total cost of closings | (2,294,112) | (1,631,534) | (1,178,484) | (904,921) | (586,914) |
| Gross profit | 706,990 | 408,470 | 292,517 | 214,896 | 157,260 |
| Commissions and other sales costs | (160,114) | (116,527) | (92,904) | (65,291) | (41,085) |
| General and administrative expenses | (124,979) | (79,257) | (53,929) | (41,496) | (35,722) |
| Earnings from unconsolidated entities, net | 18,337 | 2,788 | 1,743 | 1,383 | 1,006 |
| Other income, net | 7,468 | 9,284 | 4,033 | 4,052 | 1,878 |
| Loss on extinguishment of debt | (31,477) | | | | (383) |
| Earnings before income taxes | 416,225 | 224,758 | 151,460 | 113,544 | 82,954 |
| Income taxes | (160,560) | (85,790) | (57,054) | (43,607) | (32,295) |
| Net earnings | \$ 255,665 | \$ 138,968 | \$ 94,406 | \$ 69,937 | \$ 50,659 |
| Earnings per common share:(1) | | | | | |
| Basic | \$ 9.48 | \$ 5.33 | \$ 3.62 | \$ 2.82 | \$ 2.39 |
| Diluted | \$ 8.88 | \$ 5.03 | \$ 3.42 | \$ 2.66 | \$ 2.15 |
| Balance Sheet Data (December 31): | | | | | |
| Real estate (2) | \$ 1,390,803 | \$ 867,218 | \$ 678,011 | \$ 484,970 | \$ 330,238 |
| Total assets (2) | 1,971,357 | 1,265,394 | 954,539 | 691,788 | 436,715 |
| Senior notes, loans payable and other borrowings (2) | 592,124 | 471,415 | 351,491 | 264,927 | 177,561 |
| Total liabilities (2) | 1,120,352 | 742,839 | 542,644 | 374,480 | 260,128 |
| Stockholders' equity | 851,005 | 522,555 | 411,895 | 317,308 | 176,587 |

| | Historical Consolidated Financial Data | | | | |
|-----------------------------|--|-------------|--------------|-------------|--------------|
| | Years Ended December 31, | | | | |
| | (\$ in thousands, except per share amounts) | | | | |
| | 2005 | 2004 | 2003 | 2002 | 2001 |
| Cash Flow Data: | | | | | |
| Cash provided by (used in): | | | | | |
| Operating activities | \$ 72,243 | \$ 63,869 | \$ (50,302) | \$ 1,050 | \$ (16,411) |
| Investing activities | (247,427) | (85,502) | (35,812) | (149,691) | (76,465) |
| Financing activities | 193,120 | 64,710 | 84,313 | 151,858 | 91,862 |

(1) 2001 amounts have been adjusted to reflect a 2-for-1 stock split in the form of a stock dividend that occurred in April 2002 and 2001-2004 amounts have been adjusted to reflect a 2-for-1 stock split in the form of a stock dividend that occurred in January 2005.

(2) We determined in 2005 that costs associated with models that we use to market our communities and that are built by us on lots owned by a third-party and leased from them during our sales process, are required to be included in our financial statements. We do not legally own the models, but we are reimbursed by the owner for our construction costs, and we

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have the right but not the obligation to purchase these homes. For accounting purposes we are deemed to be the owner due to our continuing involvement with these assets. At December 31, 2005 and 2004, the amount of real estate and notes and loans payable relating to such homes was \$39.3 and \$53.8 million, respectively.

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

The following discussion gives effect to the restatement discussed in Note 13 to the consolidated financial statements.

Overview

We are a leading designer and builder of single-family homes in the rapidly growing western and southern United States based on the number of home closings and revenue. We focus on providing a broad range of first-time, move-up, active adult and luxury homes to our targeted customer base. We believe that the relatively strong population, job and income growth as well as the favorable migration characteristics of our markets will continue to provide significant long-term growth opportunities for us. At December 31, 2005, we were actively selling homes in 184 communities, with base prices ranging from \$109,000 to \$1,147,000. We operate in the following geographic regions, which are presented as our reportable business segments:

West: California and Nevada
Central: Arizona, Texas and Colorado
East: Florida

We achieved record home closings, home sales, revenues and net earnings in 2005. Home closing revenue increased 49% in 2005 to \$3.0 billion and net earnings increased 84% to \$255.7 million. In 2005 we closed 9,406 homes, up 30% from 2004 and we received 10,571 new orders for homes, up 17% from 2004.

For the year ended December 31, 2005, we benefited in most of our markets from strong order demand and strong pricing power, which resulted in record orders, closings and backlog. Our ability to obtain price increases, which have exceeded increases in land and construction costs, resulted in our 2005 gross margin increasing to 23.6% from 19.9% in fiscal 2004.

At December 31, 2005, we had a backlog of 6,394 homes with a value of approximately \$2.2 billion. This backlog gives us good visibility into our projected results over the next few quarters. The homebuilding industry as a whole has generally benefited over the last few years from strong demand and pricing power. Because of the extended time period to construct homes, i.e., from the contracting of raw land through the entitlement process to the construction of homes, strong pricing power has a favorable impact on homebuilders' gross margins because the underlying land (a significant component of the cost of a home) was generally contracted for several years earlier in a lower price environment. Thus, we believe, based on our significant backlog, during the first half of 2006 we will be able to continue to achieve relatively strong gross margins, unless we experience an unusually high number of order cancellations or construction costs increase significantly. Looking beyond our backlog, however, a slowing or decline in home sale prices could have an adverse effect on our gross margins because land relating to homes will generally have been contracted for in a comparatively higher price environment. In addition, our gross margins could be adversely impacted if home price increases do not keep pace with construction cost increases.

We posted strong home order growth in 2005, receiving 10,571 new orders valued at \$3.6 billion, increases of 17% and 37%, respectively, compared to 2004. We are aware of investor concerns about demand trends. Overall, our sales orders in 2005 were strong. During the fourth quarter of 2005, we noticed a slowdown in some of our markets in the pace of new orders compared to the abnormal surge in orders in the fourth quarter of 2004, resulting in modest increases in the number of homes ordered of 1% and 8% in the value of those orders. Our West Region posted positive order growth in 2005, with an increase of 27% in the value of home orders. However, our fourth quarter order value for the West Region fell 41% year over year, reflecting slowing from the unusually robust sales pace seen in previous quarters with increases in the number of cancellations. It is our expectation that price appreciation in our more robust markets will moderate and we expect the home order rate to return to more normal and sustainable levels in 2006 and beyond.

During January and February 2006, demand moderated from the previous record-breaking pace of sales orders in some of our markets, particularly those in the West Region as discussed above, while in Texas, our sales orders remain solid and have exceeded our expectations. During the fourth quarter of 2005, we experienced an increase in cancellations from historical levels. This trend of higher cancellation rates has continued. We believe our experiences in these markets are consistent with the overall trends in the homebuilding market. In addition, during the last few months in some of our markets, we began offering our customers increased incentives and discounts as homebuilding markets moderate from the pace experienced by the industry in general during recent years. If these trends continue or worsen in 2006, we may be required to moderate our previously issued 2006 revenue and earnings per share guidance.

Our Strategy and Other Recent Developments

In general, we focus on minimizing land risk by purchasing property only after full entitlements have been obtained and typically begin development or construction immediately after close. We acquire land primarily through rolling option contracts, allowing us to purchase individual lots as our building needs dictate. These arrangements allow us to control lot inventory typically on a non-recourse basis without incurring the risks of land ownership. At December 31, 2005, we owned or had options to acquire approximately 54,100 housing lots, of which approximately 91% were under rolling option and land purchase contracts. We believe that the lots we own or have the right to acquire represent an approximate five year supply, and that we are well positioned for future growth.

We have completed eight acquisitions over the last eight years. Our recent acquisitions have provided us with an entry into important new markets. Our 2002 acquisition of Perma-Bilt Homes provided us entry into the fast growing Las Vegas market and our January 2004 acquisition of Citation Homes of Southern California provided us entry into the Los Angeles metro area market, which is the second largest single-family housing market in the United States. Our 2001 acquisition of Hancock Homes (Phoenix) and our 2002 acquisition of Hammonds Homes (Dallas, Houston and Austin) have strengthened our positions in our important Arizona and Texas markets. In 2004 we began start-up operations in Denver, Colorado, and Orlando, Florida. We began start-up operations in Reno, Nevada in 2005, and we plan to begin delivering homes there in mid-2006.

In 2005 we significantly expanded our presence in our East Region through the acquisition of Colonial Homes in February 2005 and the acquisition of Greater Homes in September 2005. Colonial Homes builds single-family homes and condominiums in the Ft. Myers/Naples market and Greater Homes builds single-family homes in the Orlando market.

In March 2005, we completed the sale of 1,035,000 shares of our common stock in a registered public offering resulting in net proceeds to the Company of approximately \$69.7 million. In addition, we completed the private placement of \$350 million in aggregate principal amount of 6.25% senior notes due 2015 which resulted in net proceeds to the Company, after commissions, discounts and fees of approximately \$344 million. We used the proceeds from these transactions to repurchase pursuant to a tender offer and consent solicitation approximately \$276.8 million of our outstanding 9.75% senior notes due 2011. In connection with this tender offer and repurchase, we recorded a one-time pre-tax charge of approximately \$31.5 million for premiums, commissions and expenses associated with the tender offer and the write-off of existing offering costs associated with the 9.75% senior notes, net of the accretion of existing note premiums on the 9.75% senior notes and taxes.

This discussion and analysis of financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America.

Critical Accounting Policies

We have established various accounting policies that govern the application of United States generally accepted accounting principles (GAAP) in the preparation and presentation of our consolidated financial statements. Our significant accounting policies are described in Note 1 of the consolidated financial statements. Certain of these policies involve significant judgments, assumptions and estimates by management that may have a material impact on the carrying value of certain assets and liabilities, and revenue and costs. We are subject to uncertainties such as the impact of future events, economic, environmental and political factors and changes in our business environment; therefore, actual results could differ from these estimates. Accordingly, the accounting estimates used in the preparation of our financial statements will change as new events occur, as more experience is acquired, as additional information is obtained and as our operating environment changes. Changes in estimates are made when circumstances warrant. Such changes in estimates and refinements in estimation methodologies are reflected in our reported results of operations and, if material, the effects of changes in estimates are disclosed in the notes to the consolidated financial statements. The judgments, assumptions and estimates we use and believe to be critical to our business are based on historical experience, knowledge of the accounts and other factors, which we believe to be reasonable under the circumstances. Because of the nature of the judgments and assumptions we have made, actual results may differ from these judgments and estimates, which could have a material impact on the carrying values of assets and liabilities and the results of our operations. Our inability to accurately estimate stock-based compensation, expenses, accruals, or an impairment of real estate or goodwill could result in charges, or income, in future periods, which relate to activities or transactions in a preceding period. The estimates and assumptions we make relating to our application of FIN 46R, if not accurate, could result in us incorrectly including, or excluding, certain contractual land acquisition arrangements or investments in unconsolidated entities as variable interest entities in, or from, respectively, our consolidated financial statements.

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

Real Estate

Real estate is stated at cost, which includes direct construction costs for homes, development period interest and certain common costs that benefit the entire community. We assess these assets for recoverability in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. SFAS 144 requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets is measured by comparing the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. Impairment losses are measured as the amount by which the carrying amount of the assets exceeds the fair value of the assets.

Goodwill

We review the carrying value of goodwill annually. In evaluating impairment, we base our estimates of fair value on an analysis of selected business acquisitions in the homebuilding industry provided to us by an independent third party. Such evaluations for impairment are significantly impacted by the amount a buyer is willing to pay in the current market for a like business. Our reporting units are determined in accordance with SFAS 142, *Goodwill and Other Intangible Assets*, which defines a reporting unit as an operating segment or one level below an operating segment.

Warranty Reserves

Warranty reserves included in other liabilities in the consolidated balance sheets. We record reserves covering our anticipated warranty costs for each home closed. We review the adequacy of warranty reserves based on historical experience and our estimate of the costs to remediate the claims, and adjust these provisions accordingly. Factors that affect our warranty liability include the number of homes sold, historical and anticipated rates of warranty claims, and cost per claim.

Off-Balance Sheet Arrangements

We invest in entities that acquire and develop land for sale to us in connection with our homebuilding operations or for sale to third parties. Our partners generally are unrelated homebuilders, land sellers and financial or other strategic partners.

Most of the unconsolidated entities through which we acquire and develop land are accounted for by the equity method of accounting because the criteria for consolidation set forth in FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (FIN 46R) have not been met. We record our investments in these entities in our consolidated balance sheets as Investments in unconsolidated entities and our pro rata share of the entities earnings or losses in our consolidated statements of earnings as Earnings from unconsolidated entities, net. See Note 4 in the accompanying financial statements for additional information related to our investments in unconsolidated entities.

We also enter into option or purchase agreements to acquire land or lots from entities, for which we generally pay non-refundable deposits. We analyze these agreements under FIN 46R to determine whether we are the primary beneficiary of the VIE created as result of these agreements using a model developed by management. If we are deemed to be the primary beneficiary of the VIE because we are obligated to absorb the majority of the expected losses, receive the majority of the residual returns, or both, we will consolidate the VIE in our consolidated financial statements. See Note 3 in the accompanying financial statements for additional information related to our off-balance sheet arrangements.

Home Closing Revenue, Home Orders and Order Backlog Segment Analysis

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

| | Years Ended December 31, | | |
|-----------------------------|--------------------------|--------------|--------------|
| | 2005 | 2004 | 2003 |
| Home Closing Revenue | | | |
| <u>Total</u> | | | |
| Dollars | \$ 2,996,946 | \$ 2,015,742 | \$ 1,461,981 |
| Homes closed | 9,406 | 7,254 | 5,642 |
| Average sales price | \$ 318.6 | \$ 277.9 | \$ 259.1 |
| West Region | | | |
| <u>California</u> | | | |
| Dollars | \$ 947,228 | \$ 628,324 | \$ 334,677 |
| Homes closed | 1,627 | 1,367 | 735 |
| Average sales price | \$ 582.2 | \$ 459.6 | \$ 455.3 |