Forestar Group Inc.
Form 10-Q
May 07, 2010

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the quarterly period ended March 31, 2010

or

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

For the transition period from __________ to __________

Commission File Number: 001-33662

FORESTAR GROUP INC.

(Exact Name of Registrant as Specified in Its Charter)

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

6300 Bee Cave Road, Building Two, Suite 500, Austin, Texas 78746

(Address of Principal Executive Offices, Including Zip Code)

(512) 433-5200

(Registrant s Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). o Yes o No

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

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

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

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

Title of Each Class	Number of Shares Outstanding as of May 5, 2010
Common Stock, par value $1.00 per share	36,416,438

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PART I FINANCIAL INFORMATION

Item 1. ***Financial Statements***

FORESTAR GROUP INC.
Consolidated Balance Sheets

	(Unaudited) First Quarter-End 2010	Year-End 2009
	(In thousands)	
ASSETS		
Cash and cash equivalents	$ 6,590	$ 21,051
Real estate	528,790	542,812
Assets held for sale	27,976	31,226
Investment in unconsolidated ventures	107,950	109,597
Timber	19,448	19,845
Receivables, net	11,542	1,841
Prepaid expense	2,302	2,587
Property and equipment, net	5,158	5,234
Deferred tax asset	45,608	40,751
Other assets	8,246	9,790
TOTAL ASSETS	$ 763,610	$ 784,734
LIABILITIES AND SHAREHOLDERS EQUITY		
Accounts payable	$ 2,452	$ 4,573
Accrued employee compensation and benefits	245	4,025
Accrued property taxes	2,794	4,302
Accrued interest	970	871
Income taxes payable	1,250	2,809
Other accrued expenses	7,050	8,269
Other liabilities	26,904	24,924
Debt	204,406	216,626
TOTAL LIABILITIES	246,071	266,399
COMMITMENTS AND CONTINGENCIES		
EQUITY		
Forestar Group Inc. shareholders equity:		
Preferred stock, par value $0.01 per share, 25,000,000 authorized shares, none issued		
Common stock, par value $1.00 per share, 200,000,000 authorized shares, 36,615,273 issued at March 31, 2010 and 36,255,336 issued at December 31, 2009	36,615	36,255
Additional paid-in capital	386,582	384,795
Retained earnings	92,904	95,876
Accumulated other comprehensive loss		(256)
	(4,266)	(4,214)

Treasury stock, at cost, 215,014 shares at March 31, 2010 and 209,544 shares at December 31, 2009		
Total Forestar Group Inc. shareholders equity	511,835	512,456
Noncontrolling interests	5,704	5,879
TOTAL EQUITY	517,539	518,335
TOTAL LIABILITIES AND EQUITY	$ 763,610	$ 784,734

Please read the notes to the consolidated financial statements.

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FORESTAR GROUP INC.
Consolidated Statements of Income
(Unaudited)

	First Quarter 2010	First Quarter 2009
	(In thousands, except per share amounts)	
REVENUES		
Real estate sales	$ 10,750	$ 14,059
Commercial operating properties and other	6,498	4,728
Real estate	17,248	18,787
Mineral resources	7,127	5,921
Fiber resources and other	1,983	4,369
	26,358	29,077
EXPENSES		
Cost of real estate sales	(5,667)	(4,742)
Cost of commercial operating properties and other	(5,002)	(3,816)
Cost of mineral resources	(322)	(347)
Cost of fiber resources	(351)	(833)
Other operating	(10,011)	(10,201)
General and administrative	(5,576)	(8,815)
	(26,929)	(28,754)
OPERATING (LOSS) INCOME	(571)	323
Equity in earnings (loss) of unconsolidated ventures	371	(572)
Interest expense	(4,546)	(5,166)
Other non-operating income	198	51
LOSS BEFORE TAXES	(4,548)	(5,364)
Income tax benefit	1,515	2,315
CONSOLIDATED NET LOSS	(3,033)	(3,049)
Less: Net loss (income) attributable to noncontrolling interests	61	(843)
NET LOSS ATTRIBUTABLE TO FORESTAR GROUP INC.	$ (2,972)	$ (3,892)
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING BASIC	36,078	35,681
NET LOSS PER COMMON SHARE BASIC	$ (0.08)	$ (0.11)

Please read the notes to the consolidated financial statements.

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

	First Quarter 2010	First Quarter 2009
	(In thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Consolidated net loss	$ (3,033)	$ (3,049)
Adjustments:		
Depreciation and amortization	2,788	2,111
Deferred income taxes	(4,994)	(3,816)
Tax benefits not recognized for book purposes	16	
Equity in (earnings) loss of unconsolidated ventures	(371)	572
Distributions of earnings of unconsolidated ventures	99	23
Distributions of earnings to noncontrolling interests	(152)	(1,495)
Share-based compensation	3,534	1,706
Non-cash real estate cost of sales	5,421	4,770
Real estate development and acquisition expenditures	(2,788)	(7,053)
Reimbursements from utility and improvement districts	183	1,731
Other changes in real estate	5	(269)
Gain on termination of timber lease	(497)	(185)
Cost of timber cut	337	796
Deferred income	557	930
Asset impairments		600
Loss on sale of assets held for sale	277	
Other	4	28
Changes in:		
Notes and accounts receivable	(9,982)	(32)
Prepaid expenses and other	269	74
Accounts payable and other accrued liabilities	(9,949)	(10,165)
Income taxes payable	(1,560)	2,214
Net cash used for operating activities	(19,836)	(10,509)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Property, equipment, software and reforestation	(326)	(1,557)
Investment in unconsolidated ventures	(705)	(830)
Return of investment in unconsolidated ventures	2,634	1,614
Proceeds from sale of assets held for sale	2,602	
Net cash provided by (used for) investing activities	4,205	(773)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments of debt	(10,370)	(14,977)
Additions to debt	11,357	26,758
Return of investment to noncontrolling interest	(399)	(170)
Exercise of stock options	518	1
Payroll taxes on restricted stock and stock options	(49)	(17)
Tax benefit from share-based compensation	52	
Other	61	24

Net cash provided by financing activities	1,170	11,619
Net (decrease) increase in cash and cash equivalents	(14,461)	337
Cash and cash equivalents at beginning of year	21,051	8,127
Cash and cash equivalents at end of period	$ 6,590	$ 8,464

Please read the notes to the consolidated financial statements.

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

Note 1 Basis of Presentation

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

We prepare our unaudited interim financial statements in accordance with U.S. generally accepted accounting principles and Securities and Exchange Commission requirements for interim financial statements. As a result, they do not include all the information and disclosures required for complete financial statements. However, in our opinion, all adjustments considered necessary for a fair presentation have been included. Such adjustments consist only of normal recurring items unless otherwise noted. We make estimates and assumptions about future events. Actual results can, and probably will, differ from those we currently estimate including those related to allocating cost of sales to real estate, minerals and fiber and measuring assets for impairment. These interim operating results are not necessarily indicative of the results that may be expected for the entire year. For further information, please read the financial statements included in our 2009 Annual Report on Form 10-K.

Note 2 New Accounting Pronouncements

In first quarter 2010, we adopted ASU 2009-17, *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*, ASU 2010-06, *Improving Disclosures about Fair Value Measurements* and ASU 2010-09, *Amendments to Certain Recognition and Disclosure Requirements*. Adoption of these pronouncements did not have a significant effect on our earnings or financial position but did result in certain additional disclosures.

Note 3 Strategic Initiatives and Assets Held for Sale

In 2009, we announced our near-term strategic initiatives to enhance shareholder value by generating significant cash flow, principally from the sale of about 175,000 acres of higher and better use (HBU) timberland. In 2009, we sold about 95,000 acres of timber and timberland in Georgia and Alabama in two transactions generating net cash proceeds of $153,851,000, which were principally used to reduce debt and pay taxes.

At first quarter-end 2010, assets held for sale includes about 74,000 acres of undeveloped land with a carrying value of $17,974,000 and related timber with a carrying value of $10,002,000. We continue to actively market this land but did not sell any land in first quarter 2010 in accordance with these initiatives.

In first quarter 2010, we sold our undivided interest in corporate aircraft resulting in net cash proceeds of $2,602,000 and loss on the sale of assets of $277,000.

Note 4 Real Estate

Real estate consists of:

	First Quarter-End 2010	Year-End 2009
	(In thousands)	
Entitled, developed and under development projects	$ 413,645	$ 427,047
Undeveloped land	91,066	91,011
Commercial operating properties	45,705	49,171
	550,416	567,229

Accumulated depreciation	(21,626)	(24,417)
	$ 528,790	$ 542,812

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Included in entitled, developed and under development projects are the estimated costs of assets we expect to convey to utility and improvement districts of $60,847,000 at first quarter-end 2010 and $60,863,000 at year-end 2009, including about $37,052,000 at first quarter-end 2010, all of which is approved for reimbursement, and $37,062,000 at year-end 2009 related to our Cibolo Canyons project near San Antonio, Texas. These costs relate to water, sewer and other infrastructure assets we have submitted to utility or improvement districts for review and approval. In first quarter 2010, we billed these districts $183,000. In first quarter 2009, we did not bill these districts. We collected $183,000 from these districts in first quarter 2010 and $1,731,000 in first quarter 2009. We expect to collect the remaining amounts billed when these districts achieve adequate tax bases to support payment.

In first quarter 2010, entitled, developed and under development projects decreased by $11,865,000 due to lender foreclosure of a lien on a condominium property in Austin, Texas, owned by a consolidated variable interest entity. The lien secured debt guaranteed by the unrelated general partner who managed day to day operations of the venture. Please read Note 7 for additional information.

We did not recognize any asset impairment charges in first quarter 2010. We recognized asset impairment charges of $600,000 in first quarter 2009 related to a condominium project in Austin, Texas.

Depreciation expense, primarily related to commercial operating properties, was $868,000 in first quarter 2010 and $446,000 in first quarter 2009 and is included in other operating expense.

Note 5 Timber

We have over 225,000 acres of timber, primarily in Georgia. The cost of timber cut and sold was $337,000 in first quarter 2010 and $796,000 in first quarter 2009.

Note 6 Noncontrolling Interests

A reconciliation of changes in shareholders equity in first quarter 2010 follows:

	Forestar Group Inc.	Noncontrolling Interests	Total
		(In thousands)	
Balance at beginning of period	$ 512,456	$ 5,879	$ 518,335
Net (loss) income	(2,972)	(61)	(3,033)
Unrealized gain	256		256
Distributions to noncontrolling interests		(551)	(551)
Contributions from noncontrolling interests		437	437
Other (primarily share-based compensation)	2,095		2,095
Balance at end of period	$ 511,835	$ 5,704	$ 517,539

Note 7 Variable Interest Entities

At first quarter-end 2010, we are the primary beneficiary of one variable interest entity that is a limited partnership that we consolidate. We are the majority owner and provided the majority of equity to the partnership which does not have sufficient equity to fund its operations. We have the authority to approve project budgets and the issuance of additional debt. The unrelated managing partner oversees the day to day operations and guarantees the debt but does not have any remaining equity in the partnership. In first quarter 2010, our real estate assets decreased by $11,865,000, debt decreased by $13,207,000 and other liabilities increased by $1,342,000 due to lender foreclosure of a lien on the partnership s only significant asset, a condominium property in Austin, Texas. At first quarter-end 2010, the limited partnership has total assets of $12,000 and total liabilities of $3,089,000. The partnership liabilities will be settled as the venture is liquidated. During first quarter 2010, we contributed $236,000 to this partnership to fund its operations.

Also at first quarter-end 2010, we are not the primary beneficiary of three variable interest entities that are partnerships we account for using the equity method. We are a nominal general partner in two of these partnerships.

We have the authority to approve project budgets and the issuance of additional debt. The unrelated managing partners oversee the day to day operations and guarantee the debt. At first quarter-end 2010, our investment in these three partnerships is $4,127,000 and is included in investment in unconsolidated ventures. These three partnerships have total assets of $73,068,000, substantially all of which represent developed and undeveloped real estate and total liabilities of $85,893,000, which principally include borrowings maturing in 2010. Our maximum exposure to loss related to these partnerships is estimated at $37,499,000, which exceeds our investment in these partnerships because we are a nominal general partner in two of these partnerships and as a result could be held liable for partnership liabilities.

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It represents the maximum loss that we could be required to recognize assuming all of the partnerships assets are worthless and does not consider the probability that a loss will be incurred or any actions we may take to mitigate any such loss. We did not make any contributions to these partnerships during first quarter 2010.

Note 8 Investment in Unconsolidated Ventures

At first quarter-end 2010, we had ownership interests ranging from 25 to 50 percent in 10 ventures that we account for using the equity method. We have no real estate ventures that are accounted for using the cost method. Our three largest ventures at first quarter-end 2010 are CL Realty, Temco and Palisades West. We own a 50 percent interest in both CL Realty and Temco, and Cousins Real Estate Corporation owns the other 50 percent interest. We own a 25 percent interest in Palisades West, Cousins Properties Incorporated owns a 50 percent interest and Dimensional Fund Advisors LP owns the remaining 25 percent interest. Information regarding these ventures follows:

CL Realty, L.L.C. was formed in 2002 for the purpose of developing residential and mixed-use communities in Texas and across the southeastern United States. At first quarter-end 2010, the venture had 14 residential and mixed-use communities, of which 10 are in Texas, 3 are in Florida and 1 is in Georgia, representing about 7,190 residential lots and 560 commercial acres.

Temco Associates, LLC was formed in 1991 for the purpose of acquiring and developing residential real estate sites in Georgia. At first quarter-end 2010, the venture had 5 residential and mixed-use communities, representing about 1,560 planned residential lots, all of which are located in Paulding County, Georgia. The venture also owns approximately 5,500 acres of undeveloped land in Paulding County, Georgia.

Palisades West LLC was formed in 2006 for the purpose of constructing a commercial office park in Austin, Texas. The project includes two office buildings totaling approximately 375,000 square feet and an accompanying parking garage. Construction of the project was completed in fourth quarter 2008 and is approximately 94 percent leased at first quarter-end 2010. Our remaining commitment for investment in this venture as of first quarter-end 2010 is $3,245,000. Effective fourth quarter 2008, we entered into a 10-year operating lease for approximately 32,000 square feet that we occupy as our corporate headquarters.

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

	First Quarter-End 2010					Year-End 2009				
	CL Realty	Temco	Palisades West	Other Ventures	Total	CL Realty	Temco	Palisades West	Other Ventures	Total
					(In thousands)					
Real estate	$ 109,798	$ 60,253	$ 122,527	$ 88,651	$ 381,229	$ 113,169	$ 60,402	$ 122,566	$ 89,507	$ 385,644
Total assets	111,129	60,612	124,706	94,973	391,420	114,598	60,751	125,396	96,711	397,456
Borrowings, principally non-recourse (a)	3,244	3,028		77,817	84,089	3,568	3,061		77,113	83,742
Total liabilities	4,405	3,277	49,698(b)	87,749	145,129	5,414	3,268	51,158(b)	88,273	148,113
Equity	106,724	57,335	75,008	7,224	246,291	109,184	57,483	74,238	8,438	249,343
Our investment in real estate ventures:										
Our share of their equity (c)	53,362	28,667	18,696	15,194	115,919	54,592	28,742	18,559	15,673	117,566
	(7,059)			(910)	(7,969)	(7,059)			(910)	(7,969)

Unrecognized deferred gain (d)										
Investment in real estate ventures	$ 46,303	$ 28,667	$ 18,696	$ 14,284	$ 107,950	$ 47,533	$ 28,742	$ 18,559	$ 14,763	$ 109,597

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

	First Quarter	
	2010	2009
	(In thousands)	
Revenues:		
CL Realty	$ 1,727	$ 1,600
Temco	1,788	857
Palisades West	3,315	1,729
Other ventures	1,865	2,163
Total	$ 8,695	$ 6,349

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	First Quarter	
	2010	2009
	(In thousands)	
Earnings:		
CL Realty	$ (144)	$ 504
Temco	1,200	(420)
Palisades West	1,124	148
Other ventures	(1,093)	1,195
Total	$ 1,087	$ 1,427
Our equity in their earnings:		
CL Realty	$ (72)	$ 252
Temco	600	(210)
Palisades West	279	37
Other ventures (c)	(436)	(651)
Total	$ 371	$ (572)

(a) Total includes current maturities of $81,142,000 at first quarter-end 2010 and $80,625,000 at year-end 2009.

(b) Principally includes deferred income from leasehold improvements funded by tenants in excess of leasehold improvement allowances. These amounts are recognized as rental income over the lease term and are offset by depreciation expense related to these tenant improvements. There is no effect on venture net income.

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

(d) Represents deferred gains on real estate contributed by us to ventures. We are recognizing income as real estate is sold to third parties. The deferred gains are reflected as a reduction to our investment in unconsolidated ventures.

In first quarter 2010, we invested $705,000 in these ventures and received $2,733,000 in distributions; in first quarter 2009, we invested $830,000 in these ventures and received $1,637,000 in distributions. Distributions include both return of investments and distributions of earnings.

At first quarter-end 2010, other ventures include four partnerships we participate in that have about $77,817,000 of borrowings maturing in 2010. These partnerships have total assets of about $75,811,000 and other liabilities of $9,907,000. These partnerships are managed by third parties who intend to extend or refinance the borrowings maturing in 2010; however, there is no assurance that this can be done. Although these borrowings are guaranteed by third parties, we may under certain circumstances elect or be required to provide additional equity to these partnerships. Three of these partnerships are variable interest entities we account for using the equity method. Please read Note 7 for additional information. We do not believe that the ultimate resolution of these matters will have a significant effect on our earnings or financial position. Our investment in these partnerships is $4,583,000 at first quarter-end 2010.

We have provided performance bonds and letters of credit on behalf of certain ventures totaling $2,158,000 at first quarter-end 2010. Generally these performance bonds and letters of credit would be drawn on due to lack of specific performance by us or the ventures, such as failure to deliver streets and utilities in accordance with local codes and ordinances.

Note 9 Receivables

Receivables consist of:

	First Quarter-End 2010	Year-End 2009
	(In thousands)	
Seller financing notes receivable, average interest rate of 5.45% at first quarter-end 2010 and 5.76% at year-end 2009	$ 1,094	$ 1,112
Note receivable, interest rate of 9.00% at first quarter-end 2010	10,000	
Accrued interest and other	592	873
	11,686	1,985
Allowance for bad debts	(144)	(144)
	$ 11,542	$ 1,841

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Seller financing notes receivable generally are secured by a deed of trust with a minimum 10 percent down payment and are generally due within three years. Note receivable represents our loan to a third-party equity investor in the JW Marriott ® San Antonio Hill Country Resort & Spa. This note is due at the earliest of refinancing or sale of the resort hotel or July 31, 2013. Other receivables are miscellaneous operating receivables arising in the normal course of business.

Note 10 Debt

Debt consists of:

	First Quarter-End 2010	Year-End 2009
	(In thousands)	
Term loan facility average interest rate of 4.66% at first quarter-end 2010 and 4.90% at year-end 2009	$125,000	$125,000
Revolving loan facility average interest rate of 5.69% at first quarter-end 2010	3,000	
Secured promissory note interest rate of 2.75% at first quarter-end 2010 and 2.73% at year-end 2009	15,216	16,716
Other indebtedness due through 2011 at variable interest rates based on prime (3.25% at first quarter-end 2010 and year-end 2009) and fixed interest rates of 8.00%	61,190	74,910
	$204,406	$216,626

Our senior credit facility and other debt agreements contain terms, conditions and financial covenants customary for such agreements including minimum levels of interest coverage and limitations on leverage. At first quarter-end 2010, we were in compliance with the terms, conditions and financial covenants of these agreements.

At first quarter-end 2010, our senior credit facility provides for a $125,000,000 term loan and a $257,700,000 revolving line of credit. The term loan and revolving line of credit may be prepaid at any time without penalty. The senior credit facility matures December 1, 2010; however, we have the option to extend the maturity date through June 30, 2012 for up to $350,000,000. It is likely we will exercise our extension option. The revolving line of credit includes a sublimit for letters of credit equal to the lesser of $100,000,000 or 22 percent of the aggregate facility commitments, of which $3,071,000 was outstanding at first quarter-end 2010. Total borrowings under our senior credit facility (including the face amount of letters of credit) may not exceed a borrowing base formula, and includes a minimum liquidity requirement equal to the lesser of $35,000,000 or 7.5 percent of the aggregate facility commitments at each quarter-end. At first quarter-end 2010, we had $196,820,000 in net unused borrowing capacity under our senior credit facility.

At our option, we can borrow at LIBOR plus 4.5 percent (subject to a two percent LIBOR floor) or Prime plus 2.5 percent. All borrowings under the senior credit facility are secured by (a) all timberland, (b) assignments of current and future leases, rents and contracts, including our mineral leases, (c) a security interest in our primary operating account, (d) pledge of the equity interests in current and future material operating subsidiaries or joint venture interests, or if such pledge is not permitted, a pledge of the right to distributions from such entities, and (e) negative pledge (without a mortgage) on all other wholly-owned assets. The senior credit facility provides for releases of real estate to be conveyed provided that borrowing base compliance is maintained.

At first quarter-end 2010, we have $3,747,000 in unamortized origination and other fees related to our senior credit facility, which are included in other assets. Amortization of deferred financing fees in connection with our senior credit facility was $1,322,000 in first quarter 2010 and $883,000 in first quarter 2009 and is included in interest expense.

At first quarter-end 2010, commercial operating properties having a book value of $23,839,000 were subject to liens in connection with $15,216,000 of debt. At first quarter-end 2010, entitled, developed and under development projects having a book value of $129,157,000 were subject to liens in connection with $61,190,000 of principally non-recourse debt.

In first quarter 2010, other indebtedness decreased by $13,207,000 due to lender foreclosure of a lien on a condominium property in Austin, Texas owned by a consolidated variable interest entity. The lien secured debt guaranteed by the unrelated general partner who managed day to day operations of the venture. Please read Note 7 for additional information.

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Note 11 Fair Value

Our interest rate swap agreement, which was measured at fair value using the Level 2 Market approach, matured in March 2010. Please read Note 12 for additional information.

Non-financial assets measured at fair value on a non-recurring basis principally include real estate assets and assets held for sale, which are measured for impairment. In first quarter 2010, no significant non-financial assets were required to be remeasured at fair value.

We elected not to use the fair value option for cash and cash equivalents, accounts receivable, other current assets, variable debt, accounts payable and other current liabilities. The carrying amounts of these financial instruments approximate their fair values due to their short-term nature or variable interest rates.

Information about our fixed rate debt that is not measured at fair value follows:

	First Quarter-End 2010		Year-End 2009		
	Carrying Amount	Fair Value	Carrying Amount	Fair Value	Valuation Technique
	(In thousands)				
Fixed rate debt	$(3,431)	$(3,484)	$(3,431)	$(3,505)	Level 2

Note 12 Derivative Instruments

We are exposed to certain risks arising from both our business operations and economic conditions. We principally manage exposures to a wide variety of business and operational risks through management of our core business activities. We manage economic risks including interest rate and liquidity by managing the amount, sources and duration of our debt funding and through the use of derivative instruments. Specifically, we may enter into derivative instruments to mitigate the risk inherent in interest rate fluctuations.

At first quarter-end 2010, we do not have any derivative instruments outstanding. In first quarter 2010, our $100,000,000 notional amount interest rate swap agreement matured, which was classified in other liabilities at year-end 2009. As a result, we recognized an after-tax gain of $256,000 in other comprehensive income (loss). There was no hedge ineffectiveness over the term of the agreement.

Note 13 Capital Stock

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

Please read Note 19 for information about additional shares of common stock that could be issued under terms of our share-based compensation plans.

As a result of the 2007 spin-offs from Temple-Inland, at first quarter-end 2010, personnel of Temple-Inland and the other spin-off entity held 22,000 awards that will be settled in our common stock and options to purchase 1,296,000 shares of our common stock. Information about these stock options follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (Current Value Less Exercise Price)
		(Per share)	(In years)	

	(In thousands)			**(In thousands)**
Outstanding	1,296	$ 20.40	4	$ 3,472
Exercisable	1,250	$ 20.03	4	$ 3,472

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Note 14 Other Comprehensive Income (Loss)

Other comprehensive income (loss) consists of:

	First Quarter	
	2010	2009
	(In thousands)	
Consolidated net income (loss)	$ (3,033)	$ (3,049)
Change in fair value of interest rate swap agreement	393	248
Income tax effect of change in fair value	(137)	(87)
Other comprehensive income (loss)	(2,777)	(2,888)
Less: Comprehensive loss (income) attributable to noncontrolling interests	61	(843)
Other comprehensive income (loss) attributable to Forestar Group Inc.	$ (2,716)	$ (3,731)

Note 15 Earnings (Loss) per Share

Earnings (loss) per share for first quarter 2010 and 2009 was based on weighted average basic shares outstanding due to our net loss. Weighted average common shares outstanding used to compute earnings per share were:

	First Quarter	
	2010	2009
	(In thousands)	
Weighted average common shares outstanding basic	36,078	35,681
Dilutive effect of stock options		
Dilutive effect of restricted stock and restricted stock units		
Weighted average common shares outstanding diluted	36,078	35,681

At first quarter-end 2010 and 2009, the effect of 3,070,000 and 3,074,000 stock options and unvested shares of restricted stock were not included in the computation of diluted weighted average shares outstanding because they were anti-dilutive as a result of our net loss in these periods.

Note 16 Income Taxes

Our effective tax rate was a benefit of 33 percent with no benefit attributable to noncontrolling interests in first quarter 2010 and 43 percent and 6 percent in first quarter 2009. Our 2010 rate includes a benefit from percentage depletion and our 2009 rate includes benefits from percentage depletion and a federal income tax rate change for qualified timber gains due to the Food, Conservation and Energy Act of 2008 which expired in 2009.

We have not provided a valuation allowance for our deferred tax asset because we believe it is likely it will be recoverable in future periods.

Our unrecognized tax benefits totaled $7,553,000 at first quarter-end 2010, of which $6,177,000 would affect our effective tax rate, if recognized.

Note 17 Commitments and Contingencies

Litigation

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

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Environmental

Environmental remediation liabilities arise from time to time in the ordinary course of doing business, and we believe we have established adequate reserves for any probable losses. We own 288 acres near Antioch, California, portions of which were sites of a Temple-Inland paper manufacturing operation that are in remediation. We estimate the cost to complete remediation activities will be about $4,300,000, which is included in other accrued expenses and will likely be paid in 2010 and 2011. Our estimate requires us to make assumptions regarding the scope of required remediation, the effectiveness of planned remediation activities, and approvals by regulatory authorities. Our estimate is subject to revision as new information becomes available.

Note 18 Segment Information

We manage our operations through three business segments: real estate, mineral resources and fiber resources. Real estate secures entitlements and develops infrastructure on our lands for single-family residential and mixed-use communities and manages our undeveloped land and our commercial operating properties. Mineral resources includes our oil, natural gas and water interests. Fiber resources manages our timber and recreational leases.

Assets allocated by segment are as follows:

	First Quarter-End 2010	Year-End 2009
	(In thousands)	
Real estate	$ 639,643	$ 654,250
Mineral resources	3,080	1,356
Fiber resources	19,682	20,088
Assets not allocated to segments	101,205	109,040
Total assets	$ 763,610	$ 784,734

We evaluate performance based on segment earnings before unallocated items and income taxes. Segment earnings consist of operating income, equity in earnings (loss) of unconsolidated ventures and net income (loss) attributable to noncontrolling interests. Unallocated items consist of general and administrative expense, share-based compensation, gain on sale of assets, interest expense and other non-operating income and expense. The accounting policies of the segments are the same as those described in the accounting policy note to the consolidated financial statements. Our revenues are derived from our U.S. operations and all of our assets are located in the U.S. For first quarter 2010, revenues of $3,180,000 from a customer of our mineral resources segment exceeded 10 percent of our total revenues.

Segment revenues and earnings are as follows:

	First Quarter 2010	First Quarter 2009
	(In thousands)	
Revenues:		
Real estate	$ 17,248	$ 18,787
Mineral resources	7,127	5,921
Fiber resources	1,983	4,369
Total revenues	$ 26,358	$ 29,077
Segment earnings:		
Real estate	$ 312	$ 542
Mineral resources	6,178	4,782
Fiber resources	1,443	2,909

Total segment earnings	$ 7,933	$ 8,233
Items not allocated to segments [a]	(12,420)	(14,440)
Loss before taxes	$ (4,487)	$ (6,207)

[a] Items not allocated to segments consists of:

	First Quarter 2010	2009
	(In thousands)	
General and administrative expense	$ (4,538)	$ (7,619)
Share-based compensation expense	(3,534)	(1,706)
Interest expense	(4,546)	(5,166)
Other non-operating income	198	51
	$ (12,420)	$ (14,440)

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In first quarter 2009, general and administrative expense includes about $3,200,000 paid to outside advisors regarding an evaluation by our Board of Directors of an unsolicited shareholder proposal.

Share-based compensation increased in first quarter 2010 principally due to our higher stock price and greater number of vested awards.

Note 19 Share-Based Compensation

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

Cash-settled awards

Cash-settled awards granted to our employees in the form of restricted stock units or stock appreciation rights vest over two to four years from the date of grant and generally provide for accelerated vesting upon death, disability or if there is a change in control. Vesting for some awards is also conditioned upon achievement of a minimum one percent annualized return on assets over a three-year period. Cash-settled stock appreciation rights have a ten-year term, generally become exercisable ratably over three to four years and provide for accelerated or continued vesting upon retirement, death, disability or if there is a change in control. Stock appreciation rights were granted with an exercise price equal to the market value of our stock on the date of grant.

Cash-settled awards granted to our directors in the form of restricted stock units are fully vested at the time of grant and payable upon retirement.

The following table summarizes the activity of cash-settled awards granted in first quarter 2010:

	Equivalent Units (In thousands)	Weighted Average Grant Date Fair Value (Per unit)
Non-vested at beginning of period	1,005	$ 5.35
Granted	381	12.89
Vested	(246)	7.11
Forfeited	(15)	6.23
Non-vested at end of period	1,125	$ 7.51

To settle vested cash awards, we paid $602,000 in first quarter 2010 and $22,000 in first quarter 2009. The aggregate current value of non-vested awards was $12,479,000 at first quarter-end 2010.

Restricted stock

Restricted stock awards vest either ratably over or after three years, generally if we achieve a minimum one percent annualized return on assets over such three-year period. The following table summarizes the activity of awards granted in first quarter 2010:

	Restricted Shares (In thousands)	Weighted Average Grant Date Fair Value (Per share)
Non-vested at beginning of period	331	$ 17.43
Granted	308	17.80

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	Restricted Shares (In thousands)		Weighted Average Grant Date Fair Value (Per share)
Vested			
Forfeited	(3)		28.20
Non-vested at end of period	636	$	17.56

The aggregate current value of non-vested awards was $12,014,000 at first quarter-end 2010.

Stock options

Stock options have a ten-year term, generally become exercisable ratably over three to four years and provide for accelerated or continued vesting upon retirement, death, disability or if there is a change in control. Options were granted with an exercise price equal to the market value of our stock on the date of grant. The following table summarizes the activity of stock option awards granted in first quarter 2010:

	Options Outstanding (In thousands)		Weighted Average Exercise Price (Per share)	Weighted Average Remaining Contractual Term (In years)
Balance at beginning of period	780	$	24.80	8
Granted	181		17.80	
Exercised				
Forfeited	(2)		28.85	
Balance at end of period	959	$	23.47	8
Exercisable at end of period	397	$	26.86	8

At first quarter-end 2010, the aggregate intrinsic value of stock options outstanding was $1,746,000 and the aggregate intrinsic value of stock options exercisable was $388,000.

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

	First Quarter 2010	First Quarter 2009
Expected dividend yield	0.0%	0.0%
Expected stock price volatility	51.0%	41.8%
Risk-free interest rate	2.3%	1.8%
Expected life of options (years)	6	6
Weighted average estimated fair value of options granted	$8.98	$3.94

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

Pre-Spin Awards

Certain of our employees participated in Temple-Inland s share-based compensation plans. In conjunction with the 2007 spin-off, these awards were equitably adjusted into separate awards of the common stock of Temple-Inland and the spin-off entities.

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Cash-settled awards generally vest and are paid after three years from the date of grant or the attainment of defined performance goals, generally measured over a three-year period. A summary of cash-settled awards outstanding at first quarter-end 2010 follows:

	Equivalent Units (In thousands)	Aggregate Current Value (In thousands)
Awards on Forestar stock	8	$ 157
Awards on Temple-Inland stock	25	511
		$ 668

To settle vested cash awards, we paid $1,150,000 in first quarter 2010 and $394,000 in first quarter 2009.

Stock options have a ten-year term, generally become exercisable ratably over four years and provide for accelerated or continued vesting upon retirement, death, disability or if there is a change in control. A summary of stock option awards outstanding at first quarter-end 2010 follows:

	Shares (In thousands)	Weighted Average Exercise Price (Per share)	Weighted Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value (Current Value Less Exercise Price) (In thousands)
Outstanding on Forestar stock	81	$ 21.60	5	$ 201
Outstanding on Temple-Inland stock	195	18.83	5	626
				$ 827
Exercisable on Forestar stock	76	$ 20.98	5	$ 201
Exercisable on Temple-Inland stock	180	18.35	5	626
				$ 827

The intrinsic value of options exercised was $297,000 in first quarter 2010. No options were exercised in first quarter 2009.

Share-Based Compensation Expense

Share-based compensation expense consists of:

	First Quarter 2010	First Quarter 2009
	(In thousands)	
Cash-settled awards	$ 2,125	$ 780
Restricted stock	703	344

Stock options	706	582
Pre-tax share-based compensation expense	3,534	1,706
Income tax benefit	(1,166)	(631)
	$ 2,368	$ 1,075

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

	First Quarter	
	2010	**2009**
	(In thousands)	
General and administrative expense	$ 1,038	$ 1,196
Other operating expense	2,496	510
	$ 3,534	$ 1,706

In first quarter 2010, share-based compensation expense increased primarily due to increased stock price associated with vested cash-settled awards granted to retirement-eligible employees and additional awards granted.

We did not capitalize any share-based compensation in first quarter 2010 or 2009.

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Unrecognized share-based compensation for post-spin awards not vested was $10,615,000 at first quarter-end 2010. The weighted average period over which this amount will be recognized is estimated to be 2.4 years. Unrecognized share-based compensation for pre-spin awards not vested was $128,000 at first quarter-end 2010. The weighted average period over which this amount will be recognized is estimated to be 0.8 years.

In first quarter 2010, we withheld shares having a value of $49,000 in connection with vesting of restricted stock awards and exercises of stock options. These shares are accounted for as treasury stock and are reflected in financing activities in our consolidated statement of cash flows.

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

Management s Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the financial statements and Management s Discussion and Analysis of Financial Condition and Results of Operations in our 2009 Annual Report on Form 10-K. Unless otherwise indicated, information is presented as of first quarter-end 2010, and references to acreage owned includes 74,000 acres classified as assets held for sale in accordance with our near-term strategic initiatives and all acres owned by ventures regardless of our ownership interest in a venture.

Forward-Looking Statements

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

general economic, market or business conditions in Texas or Georgia, where our real estate activities are concentrated;

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

significant customer concentration

future residential or commercial entitlements, development approvals and the ability to obtain such approvals;

accuracy of estimates and other assumptions related to investment in real estate, the expected timing and pricing of land and lot sales and related cost of real estate sales, impairment of long-lived assets, income taxes, share-based compensation and oil and gas reserves;

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

the development of relationships with strategic partners;

fluctuations in costs and expenses;

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

supply of and demand for oil and gas and fluctuations in oil and gas prices;

competitive actions by other companies;

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

government regulation of exploration and production technology, including hydraulic fracturing;

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

our partners ability to fund their capital commitments and otherwise fulfill their operating and financial obligations;

water withdrawal or usage may be subject to state and local laws, regulations or permit requirements, and there is no assurance that all our water interests or rights will be available for withdrawal or use; and

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

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Other factors, including the risk factors described in Item 1A of our 2009 Annual Report on Form 10-K, may also cause actual results to differ materially from those projected by our forward-looking statements. New factors emerge from time to time and it is not possible for us to predict all such factors, nor can we assess the impact of any such factor on our business or the extent to which any factor, or combination of factors, may cause results to differ materially from those contained in any forward-looking statement.

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

Strategy

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

- Entitlement and development of real estate;
- Realization of value from minerals, water and fiber resources; and
- Strategic and disciplined investment in our business.

In 2009, we announced our near-term strategic initiatives to enhance shareholder value by generating significant cash flow, principally from the sale of about 175,000 acres of higher and better use (HBU) timberland. In 2009, we sold about 95,000 acres of timber and timberland in Georgia and Alabama in two transactions generating net cash proceeds of $153,851,000, which were principally used to reduce debt and pay taxes.

At first quarter-end 2010, assets held for sale includes about 74,000 acres of undeveloped land with a carrying value of $17,974,000 and related timber with a carrying value of $10,002,000. We continue to actively market this land but did not sell any land in first quarter 2010 in accordance with these initiatives. Market conditions for timberland have deteriorated since 2009 due to limited capital availability, increased return requirements and alternative investment options for buyers in the marketplace. As a result of these market conditions, additional time may be required to complete these initiatives.

Results of Operations

Net loss was ($2,972,000), or ($0.08) per share, in first quarter 2010, compared with net loss of ($3,892,000) or ($0.11) per share, in first quarter 2009.

A summary of our consolidated results follows:

	First Quarter	
	2010	2009
	(In thousands)	
Revenues:		
Real estate	$ 17,248	$ 18,787
Mineral resources	7,127	5,921
Fiber resources	1,983	4,369
Total revenues	$ 26,358	$ 29,077
Segment earnings:		
Real estate	$ 312	$ 542
Mineral resources	6,178	4,782
Fiber resources	1,443	2,909
Total segment earnings	7,933	8,233
Items not allocated to segments:		
General and administrative expense	(4,538)	(7,619)

Share-based compensation expense	(3,534)	(1,706)
Interest expense	(4,546)	(5,166)
Other non-operating income	198	51
Loss before taxes	(4,487)	(6,207)
Income tax benefit	1,515	2,315
Net loss attributable to Forestar Group Inc.	$ (2,972)	$ (3,892)

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Significant aspects of our results of operations follow:

First Quarter 2010

Real estate segment earnings declined principally due to lower undeveloped land sales as a result of deteriorating market conditions primary due to limited capital and alternate investment options to buyers in the marketplace.

Mineral resources segment earnings increased principally due to higher lease bonus revenues related to leasing activity in the East Texas Basin which resulted in higher lease bonus revenue per acre.

Fiber resources segment earnings decreased principally due to reduction in volume as a result of selling over 110,000 acres of timberland in 2009 and wet weather conditions.

Share-based compensation increased primarily due to additional awards granted, the effect of our higher stock price associated with vested cash-settled awards and accelerated expense recognition in conjunction with awards granted to retirement-eligible employees.

First Quarter 2009

Real estate segment earnings declined principally due to a continued decrease in the sales of residential real estate, decreased commercial sales activity and increased costs associated with asset impairments and legal reserves.

Mineral resources segment earnings declined principally due to lower lease bonus revenues, lower oil prices and increased costs associated with developing and staffing our mineral resources organization.

Fiber resources segment revenues increased as result of increased prices related to a higher mix of larger pine sawtimber sold.

General and administrative expense includes about $3,200,000 paid to outside advisors regarding an evaluation by our Board of Directors of an unsolicited shareholder proposal.

Current Market Conditions

Current market conditions in the single-family residential industry continue to be difficult, characterized by product oversupply, depressed sales volumes and prices, high unemployment rates and low consumer confidence. While all markets are being negatively affected by overall poor economic conditions, not all geographic areas and products have been affected to the same extent or with equal severity. These difficult market conditions may continue throughout 2010.

Oil prices have increased due to oil producers reducing production and inventories to match lower worldwide demand as well as the anticipation that future demand will outpace supply growth as economic activity improves. Natural gas prices have remained depressed as production remains strong and demand is low resulting in increased inventory levels. Exploration and production companies remained conservative reducing capital expenditures for drilling and lease acquisition due to lower natural gas prices. These conditions may impact the demand for new mineral leases, new exploration activity and the amount of royalty revenues we receive.

Pulpwood demand is relatively stable in our markets. The average price at which we sold fiber products is up principally due to increased pulpwood prices as a result of wet weather conditions.

Business Segments

We manage our operations through three business segments:

Real estate,