STRATUS PROPERTIES INC
Form 10-Q
November 12, 2010

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

FORM 10-Q

(Mark One)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2010
or
[ ] 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: 0-19989

Stratus Properties Inc.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	72-1211572 (I.R.S. Employer Identification No.)
98 San Jacinto Blvd., Suite 220 Austin, Texas (Address of principal executive offices)	78701 (Zip Code)

(512) 478-5788
(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. R 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 (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). R 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 o
Non-accelerated filer o	Smaller reporting company R

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

On October 29, 2010, there were issued and outstanding 7,470,117 shares of the registrant's common stock, par value $0.01 per share.

STRATUS PROPERTIES INC.
TABLE OF CONTENTS

Table of Contents

STRATUS PROPERTIES INC.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

STRATUS PROPERTIES INC.
CONSOLIDATED BALANCE SHEETS (Unaudited)
(In Thousands)

	September 30, 2010	December 31, 2009
ASSETS		
Cash and cash equivalents	$ 12,621	$ 15,398
Real estate held for sale – developed or under development	147,628	124,801
Real estate held for sale – undeveloped	78,315	57,201
Real estate held for use, net	158,193	101,863
Investment in unconsolidated affiliate	3,168	3,391
Deferred tax assets	172	8,296
Other assets	24,082	17,640
Total assets	$ 424,179	$ 328,590
LIABILITIES AND EQUITY		
Accounts payable and accrued liabilities	$ 20,927	$ 16,247
Accrued interest and property taxes	6,760	3,401
Deposits	8,772	7,700
Debt	171,693	81,105
Other liabilities	2,060	2,224
Total liabilities	210,212	110,677
Commitments and contingencies		
Equity:		
Stratus stockholders' equity:		
Preferred stock	-	-
Common stock	83	83
Capital in excess of par value of common stock	197,649	197,333
Accumulated deficit	(51,764)	(35,999)
Common stock held in treasury	(17,972)	(17,941)
Total Stratus stockholders' equity	127,996	143,476
Noncontrolling interest in subsidiary	85,971	74,437
Total equity	213,967	217,913
Total liabilities and equity	$ 424,179	$ 328,590

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

Table of Contents

STRATUS PROPERTIES INC.

CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)
(In Thousands, Except Per Share Amounts)

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Revenues:				
Real estate	$ 561	$ 2,116	$ 2,030	$ 4,201
Rental income	1,340	1,163	3,769	3,296
Commissions, management fees and other	357	65	524	869
Total revenues	2,258	3,344	6,323	8,366
Cost of sales:				
Real estate, net	1,788	2,710	5,538	6,806
Rental	704	788	2,115	2,405
Other	778	-	965	-
Depreciation	381	403	1,210	1,227
Total cost of sales	3,651	3,901	9,828	10,438
General and administrative expenses	1,495	1,818	4,898	5,832
Total costs and expenses	5,146	5,719	14,726	16,270
Operating loss	(2,888)	(2,375)	(8,403)	(7,904)
Interest income	6	66	30	327
Other income	-	-	228	567
Loss on extinguishment of debt	-	-	-	(182)
(Loss) gain on interest rate cap agreement	-	(37)	(25)	33
Loss before income taxes and equity in unconsolidated affiliate’s loss	(2,882)	(2,346)	(8,170)	(7,159)
Equity in unconsolidated affiliate’s loss	(89)	(95)	(238)	(277)
(Provision for) benefit from income taxes	(18)	844	(8,013)	2,448
Net loss	(2,989)	(1,597)	(16,421)	(4,988)
Net loss attributable to noncontrolling interest in subsidiary	467	44	656	254
Net loss attributable to Stratus common stock	$ (2,522)	$ (1,553)	$ (15,765)	$ (4,734)
Net loss per share attributable to Stratus common stock:				
Basic and diluted	$ (0.34)	$ (0.21)	$ (2.11)	$ (0.64)
Weighted average shares of common stock outstanding:				
Basic and diluted	7,470	7,435	7,464	7,439

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

Table of Contents

STRATUS PROPERTIES INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)
(In Thousands)

	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Cash flow from operating activities:		
Net loss	$ (16,421)	$ (4,988)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	1,210	1,227
Loss (gain) on interest rate cap agreement	25	(33)
Loss on extinguishment of debt	-	182
Cost of real estate sold	1,569	2,912
Deferred income taxes	7,971	(1,303)
Stock-based compensation	445	552
Equity in unconsolidated affiliate’s loss	238	277
Deposits	(2,173)	(802)
Purchases and development of real estate properties	(46,638)	(32,653)
Municipal utility district reimbursements	-	4,551
(Increase) decrease in other assets	(1,457)	615
Increase in accounts payable, accrued liabilities and other	2,049	3,249
Net cash used in operating activities	(53,182)	(26,214)
Cash flow from investing activities:		
Development of commercial leasing properties	(4,896)	(2,786)
Other development activities	(46,350)	(24,476)
Proceeds from matured U.S. treasury securities	-	15,391
Investment in unconsolidated affiliate	(15)	(1,462)
Other	-	53
Net cash used in investing activities	(51,261)	(13,280)
Cash flow from financing activities:		
Borrowings from credit facility	20,359	15,000
Payments on credit facility	(1,608)	(4,769)
Borrowings from project and term loans	76,157	4,700
Payments on project and term loans	(4,320)	(488)
Noncontrolling interest contributions	12,190	33,380
Net payments for stock-based awards	(7)	(96)
Purchases of Stratus common shares	-	(404)
Financing costs	(1,105)	-
Net cash provided by financing activities	101,666	47,323
Net (decrease) increase in cash and cash equivalents	(2,777)	7,829
Cash and cash equivalents at beginning of year	15,398	17,097
Cash and cash equivalents at end of period	$ 12,621	$ 24,926

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

4

Table of Contents

STRATUS PROPERTIES INC.
CONSOLIDATED STATEMENTS OF EQUITY (Unaudited)
(In Thousands)

Stratus Stockholders' Equity

	Common Stock				Accumulated	Common Stock Held in Treasury		Total Stratus		
	Number of Shares	At Par Value	Capital in Excess of Par Value	Accumulated Deficit	Other Comprehensive Loss	Number of Shares	At Cost	Stockholders' Equity	Noncontrolling Interest in Subsidiary	Total Equity
Balance at December 31, 2009	8,315	$ 83	$ 197,333	$ (35,999)	$ -	873	$ (17,941)	$ 143,476	$ 74,437	$ 217,913
Exercised and issued stock-based awards and other	32	-	(129)	-	-	-	-	(129)	-	(129)
Stock-based compensation	-	-	445	-	-	-	-	445	-	445
Tender of shares for stock-based awards	-	-	-	-	-	4	(31)	(31)	-	(31)
Noncontrolling interest contributions	-	-	-	-	-	-	-	-	12,190	12,190
Comprehensive income (loss):										
Net loss	-	-	-	(15,765)	-	-	-	(15,765)	(656)	(16,421)
Other comprehensive income	-	-	-	-	-	-	-	-	-	-
Total comprehensive income (loss)	-	-	-	(15,765)	-	-	-	(15,765)	(656)	(16,421)
Balance at September 30, 2010	8,347	$ 83	$ 197,649	$ (51,764)	$ -	877	$ (17,972)	$ 127,996	$ 85,971	$ 213,967
Balance at December 31, 2008	8,282	$ 83	$ 196,692	$ (30,095)	$ (3)	819	$ (17,441)	$ 149,236	$ 25,286	$ 174,522
Exercised and issued stock-based awards and other	26	-	-	-	-	-	-	-	-	-
Stock-based compensation	-	-	593	-	-	-	-	593	-	593

Tender of shares for stock-based awards	-	-	-	-	-	5	(96)	(96)	-	(96)
Purchases of Stratus common shares	-	-	-	-	-	49	(404)	(404)	-	(404)
Noncontrolling interest contributions	-	-	-	-	-	-	-	-	33,380	33,380
Comprehensive income (loss):										
Net loss	-	-	-	(4,734)	-	-	-	(4,734)	(254)	(4,988)
Other comprehensive income, net of taxes:										
Unrealized gain on U.S. treasury securities	-	-	-	-	3	-	-	3	-	3
Total comprehensive income (loss)	-	-	-	(4,734)	3	-	-	(4,731)	(254)	(4,985)
Balance at September 30, 2009	8,308	$ 83	$ 197,285	$ (34,829)	$ -	873	$ (17,941)	$ 144,598	$ 58,412	$ 203,010

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

Table of Contents

STRATUS PROPERTIES INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. GENERAL

The accompanying unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto for the year ended December 31, 2009, included in Stratus Properties Inc.'s (Stratus) Annual Report on Form 10-K (Stratus 2009 Form 10-K) filed with the Securities and Exchange Commission (SEC). In the opinion of management, the accompanying consolidated financial statements reflect all adjustments (consisting only of normal recurring items) considered necessary for a fair statement of the financial position of Stratus at September 30, 2010, and the results of operations for the three-month and nine-month periods ended September 30, 2010 and 2009, and cash flows for the nine-month periods ended September 30, 2010 and 2009. Operating results for the three-month and nine-month periods ended September 30, 2010, are not necessarily indicative of the results that may be expected for the year ending December 31, 2010.

2. EARNINGS PER SHARE

Stratus' basic and diluted net loss per share of common stock was calculated by dividing the loss by the weighted average number of common shares outstanding during the period.

Stock options and restricted stock units representing approximately 128,200 shares for the third quarter of 2010, approximately 163,500 shares for the third quarter of 2009, approximately 130,700 shares for the first nine months of 2010 and approximately 158,400 shares for the first nine months of 2009 were excluded from weighted average common shares outstanding for purposes of calculating diluted net loss per share because they were anti-dilutive.

3. JOINT VENTURE WITH CANYON-JOHNSON URBAN FUND II, L.P.

Effective May 1, 2008, Stratus entered into a joint venture with Canyon-Johnson Urban Fund II, L.P. (Canyon-Johnson) for the development of a 36-story mixed-use development in downtown Austin, Texas, anchored by a W Hotel & Residences (the W Austin Hotel & Residences project). Stratus' initial capital contributions to the joint venture totaled $31.8 million, which consisted of Stratus' purchase of a 1.76 acre tract of land located across the street from Austin City Hall, the related property and development agreements for the land and other project costs incurred by Stratus before May 1, 2008.

Stratus currently accounts for this joint venture as a variable interest entity (VIE) of which Stratus is the primary beneficiary. As a result, the assets, liabilities and results of operations of the joint venture are included in Stratus' consolidated financial statements.

Stratus is the manager of, and has an approximate 40 percent interest in, the joint venture. Canyon-Johnson has an approximate 60 percent interest in the joint venture. Decisions for the joint venture are made by unanimous vote of the partners. In the aggregate, Canyon-Johnson will contribute approximately 60 percent of the joint venture's required capital and Stratus will contribute approximately 40 percent. As of September 30, 2010, capital contributions totaled $65.3 million for Stratus and $87.3 million for Canyon-Johnson. The joint venture has a construction loan and a second lien loan to finance the remaining project costs (see below).

On October 21, 2009, the joint venture obtained construction financing from Beal Bank Nevada (Beal Bank) (Beal Bank loan agreement). Pursuant to the Beal Bank loan agreement, the joint venture may borrow up to an aggregate of $120 million to fund the construction, development and marketing costs of the W Austin Hotel & Residences project. On September 30, 2010, the Beal Bank loan agreement had an outstanding balance of $45.0 million and further advances are expected to be made monthly until the loan is fully funded.

On April 6, 2010, Stratus and Canyon-Johnson entered into a $30 million loan agreement with Hunter's Glen/Ford Investments I LLC (the Ford loan agreement) effective as of March 31, 2010, secured by a second lien on the W

Austin Hotel & Residences project assets to fund construction, development and marketing costs of the W Austin Hotel & Residences project. See Note 5 for further discussion of the Ford loan agreement.

On August 1, 2008, the joint venture paid $0.7 million to enter into an agreement to cap the floating London Interbank Offered Rate (LIBOR) on the W Austin Hotel & Residences project construction loan at 4.5 percent (see Note 4). The LIBOR cap notional amount varies based on originally projected loan balances. The agreement terminates on July 1, 2011.

A Stratus subsidiary has been designated as the developer of the W Austin Hotel & Residences project and will be paid a $6.0 million developer's fee over the term of construction. Stratus received development fees totaling $0.5

Table of Contents

million in each of the third quarters of 2010 and 2009 and $1.4 million in each of the first nine months of 2010 and 2009, which have been eliminated in consolidation. Development fees received through September 30, 2010, totaled $3.5 million.

Upon formation of the joint venture, Stratus performed an initial evaluation and concluded that the joint venture was a VIE and that Stratus was the primary beneficiary. Stratus reevaluated the primary beneficiary of the joint venture upon adoption of new consolidation guidance, effective January 1, 2010, (see Note 8) and concluded that Stratus is still the primary beneficiary, as Stratus has the power to direct the activities that most significantly impact the joint venture's financial performance. Stratus also reevaluated the VIE status and primary beneficiary of the joint venture as of the amendments to the operating agreement (March 31, 2010, and June 24, 2010), and concluded that the joint venture is still a VIE, and Stratus is still the primary beneficiary. Accordingly, the W Austin Hotel & Residences project has been consolidated in Stratus' financial statements. Stratus will continue to periodically evaluate the primary beneficiary of this joint venture in accordance with applicable accounting guidance.

At September 30, 2010, Stratus' consolidated balance sheet includes $266.9 million in total assets and $108.1 million in total liabilities associated with the W Austin Hotel & Residences project. The assets associated with the W Austin Hotel & Residences project can only be used to settle obligations of the joint venture. The $266.9 million of total assets associated with the project included $4.4 million of cash and cash equivalents, $114.8 million of real estate held for sale – developed or under development, $130.4 million of real estate held for use and $17.3 million of other assets. The $108.1 million of total liabilities associated with the project included $20.5 million of accounts payable and accrued liabilities, $4.1 million of accrued interest and property taxes, $8.5 million of deposits and $75.0 million of debt. Stratus also guarantees certain obligations of the W Austin Hotel & Residences project (see Note 5).

Profits and losses between partners in a real estate venture should be allocated based on how changes in net assets of the venture would affect cash payments to the investors over the life of the venture and on its liquidation. The amount of the ultimate profits earned by the W Austin Hotel & Residences project will affect the ultimate profit sharing ratios because of provisions in the joint venture agreement which would require Stratus to return certain previously received distributions to Canyon-Johnson under certain circumstances. Accordingly, the W Austin Hotel & Residences project's cumulative profits or losses are allocated based on a hypothetical liquidation of the venture's net assets as of each balance sheet date because of the uncertainty of the ultimate profits and, therefore, profit-sharing ratios. At September 30, 2010, the cumulative losses for the W Austin Hotel & Residences project were allocated based on 43 percent for Stratus and 57 percent for Canyon-Johnson.

4. FAIR VALUE MEASUREMENTS

Fair value accounting guidance includes a fair value hierarchy that is intended to increase consistency and comparability in fair value measurements and related disclosures. The fair value hierarchy is based on inputs to valuation techniques that are used to measure fair value that are either observable or unobservable. Observable inputs reflect assumptions market participants would use in pricing an asset or liability based on market data obtained from independent sources while unobservable inputs reflect a reporting entity's pricing based upon their own market assumptions.

The fair value hierarchy consists of the following three levels:

Level 1 – Inputs are quoted prices in active markets for identical assets or liabilities.

Level 2 – Inputs are quoted prices for similar assets or liabilities in an active market, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable and market-corroborated inputs which are derived principally from or corroborated by observable market data.

Level 3 – Inputs are derived from valuation techniques in which one or more significant inputs or value drivers are unobservable.

As of September 30, 2010, Stratus' financial assets measured at fair value on a recurring basis totaled less than $1 thousand.

Table of Contents

Summarized below are the carrying values and estimated fair values of financial assets and liabilities (in thousands).

	September 30, 2010		December 31, 2009	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Cash and cash equivalentsa	$ 12,621	$ 12,621	$ 15,398	$ 15,398
Accounts and notes receivablea	517	517	1,734	1,734
Interest rate cap agreementb	-c	-c	25	25
Accounts payable, accrued liabilities, accrued interest and property taxesa	27,687	27,687	19,648	19,648
Debtd	171,693	170,534	81,105	78,571

a. Fair value approximates the carrying amounts because of the short-term nature of these instruments.

b. Recorded at fair value. Observable inputs, such as LIBOR, are used to determine fair value (see below).

c. Rounds to less than $1 thousand.

d. Generally recorded at cost. Fair value of substantially all of Stratus' debt is estimated based on discounted future expected cash flows at estimated current interest rates. The fair value of debt does not represent the amounts that will ultimately be paid upon the maturities of the loans.

Interest Rate Cap Agreement. On August 1, 2008, the joint venture between Stratus and Canyon-Johnson entered into an agreement to cap the floating LIBOR rate on its W Austin Hotel & Residences project construction loan at 4.5 percent through July 1, 2011, to manage interest rate risk (see Note 3). Stratus uses an interest rate pricing model that relies on market observable inputs such as LIBOR to measure the fair value of the interest rate cap agreement. Stratus also evaluated the counterparty credit risk associated with the interest rate cap agreement, which is considered a Level 3 input, but did not consider such risk to be significant. Therefore, the interest rate cap agreement is classified within Level 2 of the fair value hierarchy. Stratus recorded non-cash charges totaling less than $1 thousand in the third quarter of 2010, $25 thousand in the first nine months of 2010 and $37 thousand in the third quarter of 2009, and non-cash gains totaling $33 thousand in the first nine months of 2009 related to fluctuations in fair value of the interest rate cap agreement.

5. DEBT TRANSACTIONS

Ford Loan Agreement. On April 6, 2010, Stratus and Canyon-Johnson entered into a $30 million loan agreement with Hunter's Glen/Ford Investments I LLC (the Ford loan agreement) effective as of March 31, 2010, secured by a second lien on the W Austin Hotel & Residences project assets. Amounts borrowed under the Ford loan agreement bear interest at an annual rate equal to 17.5 percent. Interest will accrue and can either be paid annually or added to the principal. The outstanding principal and accrued unpaid interest are due at maturity on March 31, 2012. The lender will have the option to extend the loan maturity date on the Ford loan agreement for two additional one-year periods upon payment by the joint venture of a $50,000 extension fee for each of the respective extension options exercised. Optional prepayments made after the first anniversary are not subject to prepayment premiums or fees. In addition, after one year from the first borrowing, the lender, with permission from Beal Bank, may require prepayment, but solely from the proceeds from the sale of W Austin Hotel & Residences project residential units. Stratus has guaranteed payment of principal and interest under the loan and completion of the project in connection with this loan agreement. In addition, the Ford loan agreement contains a covenant requiring that Stratus maintain a minimum total stockholders' equity balance of $120 million. Stratus' total stockholders' equity balance was $128.0 million at September 30, 2010.

Additionally, the Ford loan agreement provides for a profits interest in the joint venture. The profits interest provides that Ford will receive 95 percent of the operating cash flow and net proceeds from capital events of the joint venture up to a maximum payment of $750,000 if paid on the first anniversary date of the Ford loan agreement and increased each full or partial month thereafter by $62,500 until the Ford loan and profits interest are paid in full.

An initial advance under the Ford loan agreement of $10 million was made at closing, and the remaining $20 million was advanced during second-quarter 2010.

Comerica Credit Facility. On April 7, 2010, Stratus extended and modified its credit facility with Comerica, effective as of March 31, 2010, such that the existing $45 million facility was replaced with a $35 million revolving loan and a

Table of Contents

$10 million term loan. Any amounts repaid under the $10 million term loan are not available for future advance to Stratus. The applicable interest rate for the revolving loan is LIBOR plus 4 percent, with a minimum rate of 6 percent, and the applicable interest rate for the term loan is LIBOR plus 5 percent, with a minimum rate of 7 percent. The outstanding principal from both loans is due at maturity on May 30, 2012.

Interest payments are due monthly on amounts outstanding under the $35 million revolving loan. The $10 million term loan will require monthly interest only payments for the first year, and quarterly principal payments of $0.5 million beginning on June 1, 2011, in addition to the monthly interest payments. In addition, any distributions received by Stratus from its investment in the W Austin Hotel & Residences project shall, after repayment of any amounts due under the Beal Bank and Ford loan agreements, be paid to Comerica and applied against the $10 million term loan to the extent of any outstanding amounts. The revised Comerica revolving loan and term loan agreements also increase Stratus' minimum net worth covenant from $80 million to $120 million.

Unsecured Term Loans. On April 7, 2010, Stratus extended and modified its seven unsecured term loans with First American Asset Management (FAAM) effective as of March 31, 2010. Stratus repaid $2.0 million in March 2010, and $2.0 million in June 2010, and the remaining maturities are $9.0 million in December 2011, $3.5 million in December 2012, $15.0 million in December 2013 and $8.5 million in December 2014. The applicable interest rate for all seven unsecured term loans is 8.75 percent. In addition, the debt service coverage ratio covenant contained in the loan agreements was modified such that Stratus will remain compliant with the covenant so long as Stratus maintains total stockholders' equity of no less than $120 million. The modified loan agreements prohibit common stock repurchases while any of the loans are outstanding. The modified loan agreements for three of the loans totaling $18.5 million maturing in 2012 and 2013 prohibit prepayment before December 31, 2010. From January 1, 2011, until one year prior to the maturity dates, Stratus may prepay the loans, subject to applicable prepayment penalties. Beginning one year prior to the maturity dates, Stratus may prepay the loans with no prepayment penalties. The modified loan agreements for two of the loans totaling $8.5 million maturing in 2014 prohibit prepayment before December 31, 2011. From January 1, 2012 to December 31, 2013, Stratus may prepay the loans, subject to applicable prepayment penalties. Beginning January 1, 2014, Stratus may prepay the loans with no prepayment penalties.

Beal Bank Loan. On October 21, 2009, the joint venture obtained construction financing from Beal Bank Nevada (Beal Bank) (Beal Bank loan agreement). Pursuant to the Beal Bank loan agreement, the joint venture may borrow up to an aggregate of $120 million to fund the construction, development and marketing costs of the W Austin Hotel & Residences project. An initial advance under the Beal Bank loan agreement of $3.4 million was made at closing. On September 30, 2010, the Beal Bank loan agreement had an outstanding balance of $45.0 million and further advances are expected to be made monthly until the loan is fully funded.

Effective June 30, 2010, the joint venture and Beal Bank entered into a modification agreement, which increased the annual interest rate applicable to amounts borrowed under the Beal Bank loan agreement to The Wall Street Journal Prime Rate, as it changes from time to time, plus 6.75 percent. The prior applicable annual interest rate was The Wall Street Journal Prime Rate, as it changes from time to time, plus 6.25 percent.

Interest Capitalization. Stratus capitalized all of its interest costs totaling $3.8 million in the third quarter of 2010, $1.3 million in the third quarter of 2009, $8.4 million in the first nine months of 2010 and $4.0 million in the first nine months of 2009.

6. INCOME TAXES

As further described in Notes 1 and 7 of the Stratus 2009 Form 10-K, Stratus recognizes deferred tax assets and liabilities based on the tax effects of temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, and for tax credits. Stratus periodically evaluates its deferred taxes for recoverability considering the relative impact of negative and positive evidence, including historical profitability and projections of future taxable income. Stratus establishes a valuation allowance to reduce its deferred tax assets and records a corresponding charge to earnings if it is determined, based on available evidence at the time, that it is more likely than not that any portion of the deferred tax assets will not be realized. In evaluating the need for a valuation allowance, Stratus estimates future taxable income based on projections and ongoing tax strategies. This process involves significant management judgment about assumptions that are subject to change based on variances between projected and actual operating performance and changes in Stratus' business environment or operating or financing plans.

Stratus' deferred tax assets (net of deferred tax liabilities) before any valuation allowances totaled $8.4 million at December 31, 2009, and $10.8 million at September 30, 2010. At December 31, 2009, Stratus had a deferred tax

Table of Contents

asset valuation allowance of $58,000. Stratus provided additional valuation allowances against its net deferred tax asset totaling $9.8 million in second-quarter 2010 and $0.8 million in third-quarter 2010. In evaluating the recoverability of these deferred tax assets, Stratus considered available positive and negative evidence, giving greater weight to the recent current losses, the absence of taxable income in the carry back period and uncertainty regarding projected future financial results. As a result, Stratus concluded that there was not sufficient positive evidence supporting the realizability of its deferred tax assets beyond an amount totaling $0.2 million.

Stratus' future results of operations may be negatively impacted by its inability to realize a tax benefit for future tax losses or for items that will generate additional deferred tax assets. Stratus' future results of operations may be favorably impacted by reversals of valuation allowances if Stratus is able to demonstrate sufficient positive evidence that its deferred tax assets will be realized.

The difference between Stratus' consolidated effective income tax rate for the first nine months of 2010 and the U.S. federal statutory tax rate of 35 percent was primarily attributable to the change in Stratus' deferred tax asset valuation allowance.

The difference between Stratus' consolidated effective income tax rate for the first nine months of 2009 and the U.S. federal statutory rate of 35 percent was primarily attributable to state income tax expense and other permanent items.

7. BUSINESS SEGMENTS

Stratus currently has two operating segments, Real Estate Operations and Commercial Leasing. The Real Estate Operations segment is comprised of all Stratus' real estate held for sale (developed, under development and undeveloped) in Austin, Texas, which consists of its properties in the Barton Creek community, the Circle C community and Lantana, and the condominium residences at the W Austin Hotel & Residences project. For definitions of these property classifications, see "Overview" located in Items 1 and 2 "Business and Properties" of the Stratus 2009 Form 10-K.

The Commercial Leasing segment primarily includes the two office buildings at 7500 Rialto Boulevard. In addition, the Commercial Leasing segment includes a retail building and a bank building in Barton Creek Village, two retail buildings and a bank building in the Circle C community, and office and retail space at the W Austin Hotel & Residences project.

Stratus uses operating income or loss to measure the performance of each segment. Stratus allocates general and administrative expenses between the segments based on projected annual revenues for each segment. Stratus also allocates the W Austin Hotel & Residences project's capital expenditures and assets between the segments based on projected cost of construction for each segment. Accordingly, the following segment information reflects management's determinations that may not be indicative of what actual financial performance of each segment would be if it were an independent entity.

Segment data presented below were prepared on the same basis as Stratus' consolidated financial statements.

	Real Estate Operationsa	Commercial Leasing	Other	Total
	(In Thousands)			
Three Months Ended September 30, 2010				
Revenues	$ 918	$ 1,340	$ -	$ 2,258
Cost of sales, excluding depreciation	(1,788)	(704)	(778)b	(3,270)
Depreciation	(49)	(332)	-	(381)

General and administrative expenses	(849)	(646)	-	(1,495)
Operating loss	$ (1,768)	$ (342)	$ (778)	$ (2,888)
Capital expenditures	$ 21,555	$ 2,177	$ 22,345c	$ 46,077
Total assets at September 30, 2010	$ 245,019	$ 49,472	$ 129,688c	$ 424,179

10

Table of Contents

	Real Estate Operationsa	Commercial Leasing	Other	Total
		(In Thousands)		
Three Months Ended September 30, 2009				
Revenues	$ 2,181	$ 1,163	$ -	$ 3,344
Cost of sales, excluding depreciation	(2,710)	(788)	-	(3,498)
Depreciation	(50)	(353)	-	(403)
General and administrative expenses	(1,134)	(684)	-	(1,818)
Operating loss	$ (1,713)	$ (662)	$ -	$ (2,375)
Capital expenditures	$ 12,079	$ 1,491	$ 10,533c	$ 24,103
Total assets at September 30, 2009	$ 191,703	$ 47,435	$ 64,551c	$ 303,689

Nine Months Ended September 30, 2010				
Revenues	$ 2,554	$ 3,769	$ -	$ 6,323
Cost of sales, excluding depreciation	(5,538)	(2,115		