MDC HOLDINGS INC
Form 10-Q
July 29, 2014

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

**(Mark One)**

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

**For the quarterly period ended June 30, 2014**

**OR**

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

**Commission File No. 1-8951**

**M.D.C. HOLDINGS, INC.**

**(Exact name of Registrant as specified in its charter)**

| | |
|---|---|
| **Delaware** | **84-0622967** |

| | |
|---|---|
| **(State or other jurisdiction of incorporation or organization)** | **(I.R.S. employer identification no.)** |

| | |
|---|---|
| **4350 South Monaco Street, Suite 500 Denver, Colorado** | **80237** |
| **(Address of principal executive offices)** | **(Zip code)** |

**(303) 773-1100**

**(Registrant's telephone number, including area code)**

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

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

| | | |
|---|---|---|
| **Large Accelerated Filer** | | **Accelerated Filer** |
| **Non-Accelerated Filer** | **(Do not check if a smaller reporting company)** | **Smaller Reporting Company** |

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

**As of July 25, 2014, 48,816,639 shares of M.D.C. Holdings, Inc. common stock were outstanding.**

**M.D.C. HOLDINGS, INC. AND SUBSIDIARIES**

**FORM 10-Q**

**FOR THE QUARTER ENDED JUNE 30, 2014**

**INDEX**

**ITEM 1. Unaudited Consolidated Financial Statements**

**M.D.C. HOLDINGS, INC.**

**Consolidated Balance Sheets.**

| | June 30, 2014 | December 31, 2013 |
|---|---|---|
| | (Dollars in thousands, except per share amounts) (Unaudited) | |
| **ASSETS** | | |
| **Homebuilding:** | | |
| Cash and cash equivalents | $100,150 | $148,634 |
| Marketable securities | 492,498 | 569,021 |
| Restricted cash | 2,188 | 2,195 |
| Trade and other receivables | 27,250 | 23,407 |
| Inventories: | | |
| Housing completed or under construction | 758,392 | 636,700 |
| Land and land under development | 837,889 | 774,961 |
| Total inventories | 1,596,281 | 1,411,661 |
| Property and equipment, net | 30,765 | 31,248 |
| Deferred tax asset, net | 160,872 | 176,262 |
| Metropolitan district bond securities (related party) | 14,291 | 12,729 |
| Prepaid and other assets | 65,374 | 53,525 |
| Total homebuilding assets | 2,489,669 | 2,428,682 |
| **Financial Services:** | | |
| Cash and cash equivalents | 29,881 | 50,704 |
| Marketable securities | 13,390 | 19,046 |
| Mortgage loans held-for-sale, net | 58,377 | 92,578 |
| Other assets | 5,244 | 4,439 |
| Total financial services assets | 106,892 | 166,767 |
| Total Assets | $2,596,561 | $2,595,449 |
| **LIABILITIES AND EQUITY** | | |
| **Homebuilding:** | | |
| Accounts payable | $34,266 | $15,046 |
| Accrued liabilities | 145,290 | 152,821 |
| Revolving credit facility | 10,000 | - |
| Senior notes, net | 1,096,112 | 1,095,620 |
| Total homebuilding liabilities | 1,285,668 | 1,263,487 |

| | | |
|---|---|---|
| **Financial Services:** | | |
| Accounts payable and accrued liabilities | 56,086 | 55,639 |
| Mortgage repurchase facility | 32,198 | 63,074 |
| Total financial services liabilities | 88,284 | 118,713 |
| Total Liabilities | 1,373,952 | 1,382,200 |
| **Stockholders' Equity** | | |
| Preferred stock, $0.01 par value; 25,000,000 shares authorized; none issued or outstanding | - | - |
| Common stock, $0.01 par value; 250,000,000 shares authorized; 48,816,639 and 48,788,887 issued and outstanding at June 30, 2014 and December 31, 2013, respectively | 488 | 488 |
| Additional paid-in-capital | 910,535 | 908,090 |
| Retained earnings | 301,730 | 293,096 |
| Accumulated other comprehensive income | 9,856 | 11,575 |
| Total Stockholders' Equity | 1,222,609 | 1,213,249 |
| Total Liabilities and Stockholders' Equity | $2,596,561 | $2,595,449 |

The accompanying Notes are an integral part of these Unaudited Consolidated Financial Statements.

**M.D.C. HOLDINGS, INC.**

**Consolidated Statements of Operations and Comprehensive Income**

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2014 | 2013 | June 30, 2014 | 2013 |
| | (Dollars in thousands, except per share amounts) (Unaudited) | | | |
| **Homebuilding:** | | | | |
| Home sale revenues | $ 430,743 | $ 400,327 | $ 749,277 | $ 732,075 |
| Land sale revenues | 518 | 1,807 | 518 | 1,807 |
| Total home and land sale revenues | 431,261 | 402,134 | 749,795 | 733,882 |
| Home cost of sales | (356,175) | (327,927) | (615,653) | (602,003) |
| Land cost of sales | (522) | (1,435) | (522) | (1,435) |
| Inventory impairments | (850) | - | (850) | - |
| Total cost of sales | (357,547) | (329,362) | (617,025) | (603,438) |
| Gross margin | 73,714 | 72,772 | 132,770 | 130,444 |
| Selling, general and administrative expenses | (49,798) | (51,908) | (98,140) | (100,109) |
| Interest and other income | 4,613 | 10,200 | 18,162 | 16,749 |
| Interest expense | - | (909) | (685) | (1,726) |
| Other expense | (1,080) | (366) | (1,693) | (722) |
| Loss on early extinguishment of debt | - | - | (9,412) | - |
| Homebuilding pretax income | 27,449 | 29,789 | 41,002 | 44,636 |
| **Financial Services:** | | | | |
| Revenues | 11,491 | 13,884 | 20,714 | 26,390 |
| Expenses | (5,615) | (6,581) | (10,539) | (12,223) |
| Interest and other income | 701 | 920 | 1,489 | 1,795 |
| Financial services pretax income | 6,577 | 8,223 | 11,664 | 15,962 |
| Income before income taxes | 34,026 | 38,012 | 52,666 | 60,598 |
| Benefit from (provision for) income taxes | (12,484) | 186,897 | (19,620) | 186,827 |
| Net income | $ 21,542 | $ 224,909 | $ 33,046 | $ 247,425 |
| Other comprehensive income (loss) related to available for sale securities, net of tax | 2,327 | (1,995) | (1,719) | 540 |
| Comprehensive income | $ 23,869 | $ 222,914 | $ 31,327 | $ 247,965 |
| Earnings per share: | | | | |
| Basic | $ 0.44 | $ 4.60 | $ 0.68 | $ 5.06 |

| | | | | |
|---|---|---|---|---|
| Diluted | $ 0.44 | $ 4.55 | $ 0.67 | $ 5.01 |
| Weighted average common shares outstanding | | | | |
| Basic | 48,640,979 | 48,478,076 | 48,613,521 | 48,410,486 |
| Diluted | 48,852,696 | 48,946,055 | 48,842,527 | 48,916,988 |
| Dividends declared per share | $ 0.25 | $ - | $ 0.50 | $ - |

The accompanying Notes are an integral part of these Unaudited Consolidated Financial Statements.

**M.D.C. HOLDINGS, INC.**

**Consolidated Statements of Cash Flows**

| | Six Months Ended June 30, | |
|---|---|---|
| | 2014 | 2013 |
| | (Dollars in thousands) (Unaudited) | |
| **Operating Activities:** | | |
| Net income | $33,046 | $247,425 |
| Adjustments to reconcile net income to net cash used in operating activities: | | |
| Loss on early extinguishment of debt | 9,412 | - |
| Stock-based compensation expense | 2,550 | 5,214 |
| Depreciation and amortization | 1,933 | 2,072 |
| Loss (gain) on sale of marketable securities | (6,356) | - |
| Amortization of discount / premiums on marketable debt securities | 422 | 1,423 |
| Deferred income tax expense (benefit) | 19,554 | (187,643) |
| Net changes in assets and liabilities: | | |
| Restricted cash | 7 | (820) |
| Trade and other receivables | (8,409) | (8,566) |
| Mortgage loans held-for-sale | 34,201 | 27,490 |
| Housing completed or under construction | (122,368) | (56,087) |
| Land and land under development | (62,746) | (138,509) |
| Prepaid expenses and other assets | (9,615) | (7,884) |
| Accounts payable and accrued liabilities | 12,097 | (30,358) |
| Net cash used in operating activities | (96,272) | (146,243) |
| **Investing Activities:** | | |
| Purchases of marketable securities | (382,279) | (312,095) |
| Maturities of marketable securities | 159,789 | 87,015 |
| Sales of marketable securities | 306,769 | 137,067 |
| Purchases of property and equipment | (1,354) | (998) |
| Net cash provided by (used in) investing activities | 82,925 | (89,011) |
| **Financing Activities:** | | |
| Payments on mortgage repurchase facility, net | (30,876) | (27,479) |
| Proceeds from issuance of senior notes | 248,375 | 346,938 |
| Repayment of senior notes | (259,118) | - |
| Advances on revolving credit facility, net | 10,000 | - |
| Dividend payments | (24,412) | - |
| Proceeds from exercise of stock options | 71 | 5,118 |
| Net cash provided by (used in) financing activities | (55,960) | 324,577 |

| | | |
|---|---|---|
| Net increase (decrease) in cash and cash equivalents | (69,307 ) | 89,323 |
| Cash and cash equivalents: | | |
| Beginning of period | 199,338 | 160,095 |
| End of period | $130,031 | $249,418 |

The accompanying Notes are an integral part of these Unaudited Consolidated Financial Statements.

**M.D.C. HOLDINGS, INC.**

**Notes to Unaudited Consolidated Financial Statements**

## 1. Basis of Presentation

The Unaudited Consolidated Financial Statements of M.D.C. Holdings, Inc. ("MDC," “the Company," “we,” “us,” or “our” which refers to M.D.C. Holdings, Inc. and its subsidiaries) have been prepared, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). Accordingly, they do not include all information and footnotes required by U.S. generally accepted accounting principles (“GAAP”) for complete financial statements. These statements reflect all normal and recurring adjustments which, in the opinion of management, are necessary to present fairly the financial position, results of operations and cash flows of MDC at June 30, 2014 and for all periods presented. These statements should be read in conjunction with MDC’s Consolidated Financial Statements and Notes thereto included in MDC’s Annual Report on Form 10-K for the year ended December 31, 2013. Certain prior year amounts have been reclassified to conform to the current year’s presentation.

## 2. Recently Adopted Accounting Standards

In July 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists* ("ASU 2013-11"). This update will require companies to present an unrecognized tax benefit, or a portion of an unrecognized tax benefit, as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, unless certain conditions exist. ASU 2013-11 was effective for our interim and annual periods beginning January 1, 2014. The adoption of ASU 2013-11 did not have a material impact on our consolidated financial position or results of operations.

## 3. Segment Reporting

Our operating segments are defined as a component of an enterprise for which discrete financial information is available and is reviewed regularly by the chief operating decision-maker, or decision-making group, to evaluate performance and make operating decisions. We have identified our chief operating decision-maker as two key executives— our Chief Executive Officer and Chief Operating Officer.

We have identified each homebuilding division as an operating segment. Our operating segments have been aggregated into the reportable segments noted below because they are similar in the following regards: (1) economic characteristics; (2) housing products; (3) class of homebuyer; (4) regulatory environments; and (5) methods used to construct and sell homes. Our homebuilding reportable segments are as follows:

West (Arizona, California, Nevada and Washington)
Mountain (Colorado and Utah)
East (Virginia, Florida and Maryland, which includes Pennsylvania, Delaware and New Jersey)

Our financial services business consists of the operations of the following operating segments: (1) HomeAmerican Mortgage Corporation ("HomeAmerican"); (2) Allegiant Insurance Company, Inc., A Risk Retention Group ("Allegiant"); (3) StarAmerican Insurance Ltd. ("StarAmerican"); (4) American Home Insurance Agency, Inc.; and (5) American Home Title and Escrow Company. Due to its contributions to consolidated pretax income we consider HomeAmerican to be a reportable segment ("Mortgage operations"). The remaining operating segments have been aggregated into one reportable segment ("Other") because they do not individually exceed 10 percent of: (1) consolidated revenue; (2) the greater of (A) the combined reported profit of all operating segments that did not report a loss or (B) the positive value of the combined reported loss of all operating segments that reported losses; or (3) consolidated assets.

Corporate is a non-operating segment that develops and implements strategic initiatives and supports our operating divisions by centralizing key administrative functions such as finance and treasury, information technology, insurance and risk management, litigation and human resources. Corporate also provides the necessary administrative functions to support MDC as a publicly traded company. A portion of the expenses incurred by Corporate are allocated to the homebuilding operating segments based on their respective percentages of assets, and to a lesser degree, a portion of Corporate expenses are allocated to the financial services segments. A majority of Corporate's personnel and resources are primarily dedicated to activities relating to the homebuilding segments, and, therefore, the balance of any unallocated Corporate expenses is included in the homebuilding segment.

**M.D.C. HOLDINGS, INC.**

**Notes to Unaudited Consolidated Financial Statements**

The table set forth below summarizes home sale revenues for our homebuilding operations and revenues for our financial services operations.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | (Dollars in thousands) | | | |
| **Homebuilding** | | | | |
| West | $189,661 | $164,514 | $326,083 | $299,493 |
| Mountain | 146,665 | 133,768 | 247,610 | 267,145 |
| East | 94,935 | 103,852 | 176,102 | 167,244 |
| Total home and land sale revenues | $431,261 | $402,134 | $749,795 | $733,882 |
| | | | | |
| **Financial Services** | | | | |
| Mortgage operations | $7,352 | $10,494 | $12,471 | $19,538 |
| Other | 4,139 | 3,390 | 8,243 | 6,852 |
| Total financial services revenues | $11,491 | $13,884 | $20,714 | $26,390 |

The following table summarizes pretax income for our homebuilding and financial services operations.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | (Dollars in thousands) | | | |
| **Homebuilding** | | | | |
| West | $16,695 | $16,779 | $29,345 | $27,390 |
| Mountain | 12,182 | 14,142 | 19,541 | 27,138 |
| East | 5,296 | 4,523 | 7,957 | 6,051 |
| Corporate | (6,724 ) | (5,655 ) | (15,841 ) | (15,943 ) |
| Total homebuilding pretax income | $27,449 | $29,789 | $41,002 | $44,636 |
| | | | | |
| **Financial Services** | | | | |
| Mortgage operations | $4,501 | $6,855 | $7,060 | $12,854 |
| Other | 2,076 | 1,368 | 4,604 | 3,108 |
| Total financial services pretax income | $6,577 | $8,223 | $11,664 | $15,962 |

| | | | | |
|---|---|---|---|---|
| Total pretax income | $34,026 | $38,012 | $52,666 | $60,598 |

The table set forth below summarizes total assets for our homebuilding and financial services operations. The assets in our West, Mountain and East segments consist primarily of inventory while the assets in our Corporate segment consist primarily of cash and cash equivalents, marketable securities and our deferred tax asset. The assets in our financial services segment consist mostly of cash and cash equivalents, marketable securities and mortgage loans held-for-sale.

**M.D.C. HOLDINGS, INC.**

**Notes to Unaudited Consolidated Financial Statements**

| | June 30, 2014 | December 31, 2013 |
|---|---|---|
| **Homebuilding assets** | (Dollars in thousands) | |
| West | $846,832 | $760,450 |
| Mountain | 500,365 | 418,796 |
| East | 333,174 | 297,627 |
| Corporate | 809,298 | 951,809 |
| Total homebuilding assets | $2,489,669 | $2,428,682 |
| | | |
| **Financial services assets** | | |
| Mortgage operations | $66,206 | $99,065 |
| Other | 40,686 | 67,702 |
| Total financial services assets | $106,892 | $166,767 |
| | | |
| Total assets | $2,596,561 | $2,595,449 |

**4. Earnings Per Share**

A company that has participating securities (for example, holders of unvested restricted stock that has nonforfeitable dividend rights) is required to utilize the two-class method to calculate earnings per share (“EPS”) unless the treasury stock method results in lower EPS. The two-class method is an allocation of earnings/(loss) between the holders of common stock and a company’s participating security holders. Under the two-class method, earnings/(loss) for the reporting period are allocated between common shareholders and other security holders based on their respective rights to receive distributed earnings (i.e., dividends) and undistributed earnings (i.e., net income/(loss)). Currently, we have one class of security and we have participating security holders consisting of shareholders of unvested restricted stock. Basic EPS is calculated by dividing income or loss attributable to common stockholders by the weighted average number of shares of common stock outstanding. To calculate diluted EPS, basic EPS is further adjusted to include the effect of potential dilutive stock options outstanding. The following table shows basic and diluted EPS calculations:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | (Dollars in thousands, except per share amounts) | | | |
| **Numerator** | | | | |

| | | | | |
|---|---|---|---|---|
| Net income | $21,542 | $224,909 | $33,046 | $247,425 |
| Less: distributed earnings allocated to participating securities | (49) | - | (101) | - |
| Less: undistributed earnings allocated to participating securities | (37) | (2,069) | (39) | (2,310) |
| Net income attributable to common stockholders (numerator for basic earnings per share) | 21,456 | 222,840 | 32,906 | 245,115 |
| Add back: undistributed earnings allocated to participating securities | 37 | 2,069 | 39 | 2,310 |
| Less: undistributed earnings reallocated to participating securities | (37) | (2,049) | (38) | (2,286) |
| Numerator for diluted earnings per share under two class method | $21,456 | $222,860 | $32,907 | $245,139 |
| | | | | |
| **Denominator** | | | | |
| Weighted-average common shares outstanding | 48,640,979 | 48,478,076 | 48,613,521 | 48,410,486 |
| Add: dilutive effect of stock options | 211,717 | 467,979 | 229,006 | 506,502 |
| Denominator for diluted earnings per share under two class method | 48,852,696 | 48,946,055 | 48,842,527 | 48,916,988 |
| | | | | |
| Basic Earnings Per Common Share | $0.44 | $4.60 | $0.68 | $5.06 |
| Diluted Earnings Per Common Share | $0.44 | $4.55 | $0.67 | $5.01 |

**M.D.C. HOLDINGS, INC.**

**Notes to Unaudited Consolidated Financial Statements**

Diluted EPS for the three and six months ended June 30, 2014 excluded options to purchase approximately 4.2 million and 4.0 million shares, respectively, of common stock because the effect of their inclusion would be anti-dilutive. For the same periods in 2013, diluted EPS excluded options to purchase approximately 3.2 million and 3.1 million shares, respectively.

**5. Accumulated Other Comprehensive Income**

The following table sets forth our changes in accumulated other comprehensive income:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | (Dollars in thousands) | | | |
| Unrealized gains (losses) on available-for-sale marketable securities [1] : | | | | |
| Beginning balance | $3,609 | $7,373 | $7,655 | $4,838 |
| Other comprehensive income before reclassifications | 1,633 | (5,274) | 1,600 | (3,053) |
| Amounts reclassified from accumulated other comprehensive income [2] | 104 | (1,215) | (3,909) | (901 ) |
| Ending balance | $5,346 | $884 | $5,346 | $884 |
| Unrealized gains on available-for-sale metropolitan district bond securities [1] : | | | | |
| Beginning balance | $3,920 | $- | $3,920 | $- |
| Other comprehensive income before reclassifications | 590 | 4,494 | 590 | 4,494 |
| Amounts reclassified from accumulated other comprehensive income | - | - | - | - |
| Ending balance | $4,510 | $4,494 | $4,510 | $4,494 |
| Total ending accumulated other comprehensive income | $9,856 | $5,378 | $9,856 | $5,378 |

1. All amounts net-of-tax.
2. See separate table below for details about these reclassifications.

The following table sets forth the activity related to reclassifications out of accumulated other comprehensive income (loss) related to available for sale securities:

| Affected Line Item in the Statements of Operations | Three Months Ended June 30, 2014 | Three Months Ended June 30, 2013 | Six Months Ended June 30, 2014 | Six Months Ended June 30, 2013 |
|---|---|---|---|---|
| | (Dollars in thousands) | | | |
| Homebuilding interest and other income | $(176) | $1,166 | $6,361 | $871 |
| Financial services interest and other income | 7 | 49 | (5) | 30 |
| Income before income taxes | (169) | 1,215 | 6,356 | 901 |
| Benefit from (provision for) income taxes | 65 | - | (2,447) | - |
| Net income | $(104) | $1,215 | $3,909 | $901 |

**6. Fair Value Measurements**

Accounting Standards Codification ("ASC") Topic 820, *Fair Value Measurements* ("ASC 820"), defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. ASC 820 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs for which little or no market data exists, therefore requiring an entity to develop its own assumptions.

**M.D.C. HOLDINGS, INC.**

**Notes to Unaudited Consolidated Financial Statements**

The following table sets forth the fair values and methods used for measuring the fair values of financial instruments on a recurring basis:

| Financial Instrument | Hierarchy | Fair Value June 30, 2014 | December 31, 2013 |
|---|---|---|---|
| | | (Dollars in thousands) | |
| Marketable securities (available-for-sale) | | | |
| Equity securities | Level 1 | $465,115 | $389,323 |
| Debt securities - maturity less than 1 year | Level 2 | 2,079 | 72,577 |
| Debt securities - maturity 1 to 5 years | Level 2 | 21,723 | 106,566 |
| Debt securities - maturity greater than 5 years | Level 2 | 16,971 | 19,601 |
| Total available-for-sale securities | | $505,888 | $588,067 |
| Mortgage loans held-for-sale, net | Level 2 | $58,377 | $92,578 |
| Metropolitan district bond securities (related party) (available-for-sale) | Level 3 | $14,291 | $12,729 |

The following methods and assumptions were used to estimate the fair value of each class of financial instruments.

The fair value of our cash and cash equivalents, restricted cash, trade and other receivables, inventories, prepaid and other assets, accounts payable, and accrued liabilities approximate their carrying value.

*Marketable Securities*. We have marketable debt and equity securities. Our equity securities consist primarily of holdings in mutual fund securities, which invest mostly in debt securities. The remaining equity securities in our investment portfolio are holdings in corporate equities. Our debt securities consist primarily of fixed and floating rate interest earning debt securities, which may include, among others, United States government and government agency debt and corporate debt. We measure the fair value of our debt securities using a third party pricing service that either provides quoted market prices in active markets for identical or similar securities, which are level 1 inputs, or uses observable inputs for their pricing, which are level 2 inputs. As of June 30, 2014 and December 31, 2013, all of our marketable securities were treated as available-for-sale investments and, as such, we have recorded all of our marketable securities at fair value with changes in fair value being recorded as a component of accumulated other comprehensive income.

The following table sets forth the amortized cost and estimated fair value of our available-for-sale marketable securities.

| | June 30, 2014 | | December 31, 2013 | |
|---|---|---|---|---|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| | (Dollars in thousands) | | | |
| **Homebuilding:** | | | | |
| Equity securities | $453,152 | $460,925 | $375,142 | $385,303 |
| Debt securities | 31,051 | 31,573 | 181,635 | 183,718 |
| Total homebuilding available-for-sale securities | $484,203 | $492,498 | $556,777 | $569,021 |
| | | | | |
| **Financial Services:** | | | | |
| Equity securities | $4,000 | $4,190 | $4,000 | $4,020 |
| Debt securities | 8,950 | 9,200 | 14,721 | 15,026 |
| Total financial services available-for-sale debt securities | $12,950 | $13,390 | $18,721 | $19,046 |
| | | | | |
| Total available-for-sale marketable securities | $497,153 | $505,888 | $575,498 | $588,067 |

As of June 30, 2014 and December 31, 2013, our marketable securities were in net unrealized gain positions totaling $8.7 million and $12.6 million, respectively. Our marketable securities that were in unrealized loss positions aggregated to unrealized losses of $0.7 million and $1.1 million as of June 30, 2014 and December 31, 2013, respectively. The table below sets forth the debt and equity securities that were in an aggregate loss position. We do not believe that the aggregate unrealized loss related to our debt or equity securities as of June 30, 2014 is material to our operations.

**M.D.C. HOLDINGS, INC.**

**Notes to Unaudited Consolidated Financial Statements**

| | June 30, 2014 | | | December 31, 2013 | | |
|---|---|---|---|---|---|---|
| | Number of Securities in Loss Position | Aggregate Loss Position | Aggregate Fair Value of Securities in a Loss Position | Number of Securities in Loss Position | Aggregate Loss Position | Aggregate Fair Value of Securities in a Loss Position |
| Type of Investment | (Dollars in thousands) | | | | | |
| Debt | 40 | $ (221) | $ 12,509 | 72 | $ (430) | $ 46,440 |
| Equity | 3 | (480) | 108,403 | 7 | (713) | 14,174 |
| Total | 43 | $ (701) | $ 120,912 | 79 | $ (1,143) | $ 60,614 |

The following tables set forth gross realized gains and losses from the sale of available-for-sale marketable securities, which were included in either interest and other income in the homebuilding section or interest and other income in the financial services section of our consolidated statements of operations.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | (Dollars in thousands) | | | |
| Gross realized gains on sales of available-for-sale securities | | | | |
| Equity securities | $ - | $ 216 | $ 5,518 | $ 216 |
| Debt securities | 100 | 128 | 1,920 | 260 |
| Total | $ 100 | $ 344 | $ 7,438 | $ 476 |
| | | | | |
| Gross realized losses on sales of available-for-sale securities | | | | |
| Equity securities | $ (467) | $ - | $ (709) | $ - |
| Debt securities | (182) | (1,006) | (373) | (1,225) |
| Total | $ (649) | $ (1,006) | $ (1,082) | $ (1,225) |
| | | | | |
| Net realized gain (loss) on sales of available-for-sale securities | $ (549) | $ (662) | $ 6,356 | $ (749) |

*Mortgage Loans Held-for-Sale, Net.* As of June 30, 2014, the primary components of our mortgage loans held-for-sale that are measured at fair value on a recurring basis are: (1) mortgage loans held-for-sale under commitments to sell; and (2) mortgage loans held-for-sale not under commitments to sell. At June 30, 2014 and December 31, 2013, we had $48.9 million and $66.1 million, respectively, of mortgage loans held-for-sale under commitments to sell for which fair value was based upon Level 2 inputs, which were the quoted market prices for those mortgage loans. At June 30, 2014 and December 31, 2013, we had $9.5 million and $26.5 million, respectively, of mortgage loans held-for-sale that were not under commitments to sell. The fair value for those loans was primarily based upon the estimated market price received from an outside party, which is a Level 2 fair value input.

*Metropolitan District Bond Securities (Related Party).* The Metropolitan district bond securities (the “Metro Bonds”) are included in the homebuilding section of our accompanying consolidated balance sheets. We acquired the Metro Bonds from a quasi-municipal corporation in the state of Colorado (the “Metro District”), which was formed to help fund and maintain the infrastructure associated with a master-planned community being developed by our Company. Cash flows received by the Company from these securities reflect principal and interest payments from the Metro District that are supported by an annual levy on the taxable value of real estate and personal property within the Metro District’s boundaries and a one-time fee assessed on permits obtained by MDC in the Metro District. The stated year of maturity for the Metro Bonds is 2037. However, if the unpaid principal and all accrued interest are not paid off by the year 2037, the Company will continue to receive principal and interest payments in perpetuity until the unpaid principal and accrued interest is paid in full. Since 2007 and through the first quarter of 2013, we accounted for these securities under the cost recovery method and they were not carried at fair value in accordance with ASC Topic 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality* (“ASC 310-30”).

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**Notes to Unaudited Consolidated Financial Statements**

In the second quarter of 2013, we determined that these securities no longer were required to be accounted for under the cost recovery method due to an increase in the number of new homes delivered in the community coupled with improvements in property values within the Metro District. In accordance with ASC 310-30, we will adjust the bond principal balance on a prospective basis using an interest accretion model that utilizes future cash flows expected to be collected. Furthermore, as this investment is accounted for as an available-for-sale asset, we will update its fair value on a quarterly basis, with the adjustment being recorded through other comprehensive income. The fair value is based upon a discounted future cash flow model, which uses Level 3 inputs. The two primary unobservable inputs used in our discounted cash flow model are the forecasted number of homes to be closed, as they drive any increases to the tax base for the Metro District, and the discount rate. The table below provides quantitative data, as of June 30, 2014, regarding each unobservable input and the sensitivity of fair value to potential changes in those unobservable inputs.

| | Quantitative Data | | Sensitivity Analysis | |
|---|---|---|---|---|
| Unobservable Input | Range | Weighted Average | Movement in Fair Value from Increase in Input | Movement in Fair Value from Decrease in Input |
| Number of homes closed per year | 0 to 120 | 93 | Increase | Decrease |
| Discount rate | 6% to 16% | 11.9% | Decrease | Increase |

The table set forth below summarizes the activity for our Metro Bonds:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, | | June 30, | |
| | 2014 | 2013 | 2014 | 2013 |
| | (Dollars in thousands) | | | |
| Balance at beginning of period | $13,027 | $5,818 | $12,729 | $5,818 |
| Increase in fair value (recorded in other comprehensive income) | 959 | 7,354 | 959 | 7,354 |
| Change due to accretion of principal | 305 | 663 | 603 | 663 |
| Cash receipts | - | - | - | - |
| Balance at end of period | $14,291 | $13,835 | $14,291 | $13,835 |

*Mortgage Repurchase Facility.* The debt associated with our Mortgage Repurchase Facility is at floating rates or at fixed rates that approximate current market rates and have relatively short-term maturities, generally within 30 days. The fair value approximates carrying value and is based on Level 2 inputs.

*Senior Notes*. The estimated values of the senior notes in the following table are based on Level 2 inputs, including market prices of other homebuilder bonds.

| | June 30, 2014 | | December 31, 2013 | |
|---|---|---|---|---|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| | (Dollars in thousands) | | | |
| 5 % Senior Notes due December 2014, net | $- | $- | $249,814 | $258,750 |
| 5 % Senior Notes due July 2015, net | 249,956 | 259,850 | 249,935 | 262,562 |
| 5 % Senior Notes due February 2020, net | 246,156 | 270,938 | 245,871 | 259,688 |
| 5½% Senior Notes due January 2024, net | 250,000 | 258,250 | - | - |
| 6% Senior Notes due January 2043 | 350,000 | 329,613 | 350,000 | 305,083 |
| Total | $1,096,112 | $1,118,651 | $1,095,620 | $1,086,083 |

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**Notes to Unaudited Consolidated Financial Statements**

**7. Inventories**

The following table sets forth, by reportable segment, information relating to our homebuilding inventories:

| | June 30, 2014 | December 31, 2013 |
|---|---|---|
| | (Dollars in thousands) | |
| Housing Completed or Under Construction: | | |
| West | $349,850 | $270,778 |
| Mountain | 236,784 | 194,101 |
| East | 171,758 | 171,821 |
| Subtotal | 758,392 | 636,700 |
| Land and Land Under Development: | | |
| West | 458,490 | 459,512 |
| Mountain | 244,853 | 211,526 |
| East | 134,546 | 103,923 |
| Subtotal | 837,889 | 774,961 |
| Total Inventories | $1,596,281 | $1,411,661 |

Our inventories are primarily associated with communities where we intend to construct and sell homes on the land, including models and unsold started homes. Costs capitalized to land and land under development primarily include: (1) land costs; (2) land development costs; (3) entitlement costs; (4) capitalized interest; (5) engineering fees; and (6) title insurance, real property taxes and closing costs directly related to the purchase of the land parcel. Components of housing completed or under construction primarily include: (1) land costs transferred from land and land under development; (2) direct construction costs associated with a house; (3) real property taxes, engineering fees, permits and other fees; (4) capitalized interest; and (5) indirect construction costs, which include field construction management salaries and benefits, utilities and other construction related costs. Land costs are transferred from land and land under development to housing completed or under construction at the point in time that construction of a home on an owned lot begins.

In accordance with ASC 360, *Property, Plant, and Equipment* ("ASC 360"), homebuilding inventories are carried at cost unless events and circumstances indicate that the carrying value of the underlying subdivision may not be recoverable. We evaluate inventories for impairment at each quarter end on a subdivision level basis as each such subdivision represents the lowest level of identifiable cash flows. In making this determination, we review, among other things, the following for each subdivision:

- actual and trending “Operating Margin” (which is defined as home sale revenues less home cost of sales and all direct incremental costs associated with the home closing, including sales commissions) for homes closed;
- estimated future undiscounted cash flows and Operating Margin;
- forecasted Operating Margin for homes in backlog;
- actual and trending net and gross home orders;
- base sales price and home sales incentive information for homes closed, homes in backlog and homes available for sale;
- market information for each sub-market, including competition levels, home foreclosure levels, the size and style of homes currently being offered for sale and lot size; and
- known or probable events indicating that the carrying value may not be recoverable.

If events or circumstances indicate that the carrying value of our inventory may not be recoverable, assets are reviewed for impairment by comparing the undiscounted estimated future cash flows from an individual subdivision to its carrying value. If the undiscounted future cash flows are less than the subdivision’s carrying value, the carrying value of the subdivision is written down to its then estimated fair value. We generally determine the estimated fair value of each subdivision by determining the present value of the estimated future cash flows at discount rates that are commensurate with the risk of the subdivision under evaluation. For the three and six months ended June 30, 2014, we recorded $0.9 million of inventory impairment charges related to two projects in our East segment. No such charges were recorded during the three and six months ended June 30, 2013.

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## 8. Capitalization of Interest

We capitalize interest to inventories during the period of development in accordance with ASC Topic 835, *Interest* ("ASC 835"). Homebuilding interest capitalized as a cost of inventories is included in cost of sales as related units or lots are sold. To the extent our homebuilding debt exceeds our qualified assets, as defined in ASC 835, we expense a portion of interest incurred. Qualified homebuilding assets consist of all lots and homes, excluding finished unsold homes or finished models, within projects that are actively selling or under development. The table set forth below summarizes homebuilding interest activity.

The homebuilding interest expensed in the table below relates to the portion of interest incurred where our homebuilding debt exceeded our qualified inventory for such periods in accordance with ASC 835.

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, | | June 30, | |
| | 2014 | 2013 | 2014 | 2013 |
| | (Dollars in thousands) | | | |
| Homebuilding interest incurred | $16,530 | $15,345 | $35,712 | $29,684 |
| Less: Interest capitalized | (16,530) | (14,436) | (35,027) | (27,958) |
| Homebuilding interest expensed | $- | $909 | $685 | $1,726 |
| | | | | |
| Interest capitalized, beginning of period | $80,928 | $72,791 | $74,155 | $69,143 |
| Interest capitalized during period | 16,530 | 14,436 | 35,027 | 27,958 |
| Less: Previously capitalized interest included in home cost of sales | (16,522) | (12,680) | (28,246) | (22,554) |
| Interest capitalized, end of period | $80,936 | $74,547 | $80,936 | $74,547 |

## 9. Homebuilding Prepaid Expenses and Other Assets

The following table sets forth the components of homebuilding prepaid expenses and other assets.

| | June 30, | December 31, |
|---|---|---|

| | 2014 | 2013 |
|---|---|---|
| | (Dollars in thousands) | |
| Land option deposits | $18,907 | $15,221 |
| Deferred marketing costs | 23,818 | 15,830 |
| Prepaid expenses | 3,648 | 4,349 |
| Goodwill | 6,008 | 6,008 |
| Deferred debt issuance costs, net | 12,601 | 11,527 |
| Other | 392 | 590 |
| Total | $65,374 | $53,525 |

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**Notes to Unaudited Consolidated Financial Statements**

**10. Homebuilding Accrued Liabilities and Financial Services Accounts Payable and Accrued Liabilities**

The following table sets forth information relating to homebuilding accrued liabilities.

| | June 30, 2014 | December 31, 2013 |
|---|---|---|
| | (Dollars in thousands) | |
| Accrued compensation and related expenses | $20,677 | $35,990 |
| Accrued executive deferred compensation | 30,796 | 30,796 |
| Accrued interest | 29,953 | 24,198 |
| Warranty reserves | 20,178 | 22,238 |
| Customer and escrow deposits | 14,685 | 10,759 |
| Land development and home construction accruals | 7,875 | 9,592 |
| Other accrued liabilities | 21,126 | 19,248 |
| Total accrued liabilities | $145,290 | $152,821 |

The following table sets forth information relating to financial services accounts payable and accrued liabilities.

| | June 30, 2014 | December 31, 2013 |
|---|---|---|
| | (Dollars in thousands) | |
| Insurance reserves | $49,363 | $49,637 |
| Accounts payable and other accrued liabilities | 6,723 | 6,002 |
| Total accounts payable and accrued liabilities | $56,086 | $55,639 |

**11. Warranty Reserves**

Our homes are sold with limited third-party warranties. We record accruals for general and structural warranty claims, as well as accruals for known, unusual warranty-related expenditures. Warranty accruals are recorded based upon historical payment experience in an amount estimated to be adequate to cover expected costs of materials and outside labor during warranty periods. The determination of the warranty accrual rate for closed homes and the evaluation of our warranty reserve balance at period end are based on an internally developed analysis that includes known facts and interpretations of circumstances, including, among other things, our trends in historical warranty payment levels and warranty payments for claims not considered to be normal and recurring.

Our warranty reserves are included in accrued liabilities in the homebuilding section of our consolidated balance sheets and adjustments to our warranty reserves are recorded as an increase or reduction to home cost of sales in the homebuilding section of our consolidated statements of operations.

The table set forth below summarizes accrual, adjustment and payment activity related to our warranty reserve for the three and six months ended June 30, 2014 and 2013. As a result of favorable warranty payment experience relative to our estimates at the time of home closing, we reduced our warranty reserve by $1.3 million and $2.1 million for the three and six months ended June 30, 2014, respectively, compared to no adjustments during the three months ended June 30, 2013 and $0.3 million in adjustments for the six months ended June 30, 2013.

The impact of the change in our warranty accrual rates from the three months ended June 30, 2014, as compared to three months ended June 30, 2013, and the six months ended June 30, 2014, as compared to six months ended June 30, 2014, did not materially affect our warranty expense or gross margin from home sales for the three and six months ended June 30, 2014.

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| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, | | June 30, | |
| | 2014 | 2013 | 2014 | 2013 |
| | (Dollars in thousands) | | | |
| Balance at beginning of period | $21,447 | $23,098 | $22,238 | $23,151 |
| Expense provisions | 1,243 | 1,154 | 2,157 | 2,276 |
| Cash payments | (1,237 ) | (1,527 ) | (2,142 ) | (3,002 ) |
| Adjustments | (1,275 ) | - | (2,075 ) | 300 |
| Balance at end of period | $20,178 | $22,725 | $20,178 | $22,725 |

## 12. Insurance Reserves

The establishment of reserves for estimated losses associated with insurance policies issued by Allegiant and re-insurance agreements issued by StarAmerican are based on actuarially developed studies that include known facts and interpretations of circumstances, including our experience with similar cases and historical trends involving claim payment patterns, pending levels of unpaid claims, product mix or concentration, claim severity, frequency patterns depending on the business conducted, and changing regulatory and legal environments.

The table set forth below summarizes the insurance reserve activity for the three and six months ended June 30, 2014 and 2013. The insurance reserve is included as a component of accrued liabilities in the financial services section of the accompanying consolidated balance sheets.

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, | | June 30, | |
| | 2014 | 2013 | 2014 | 2013 |
| | (Dollars in thousands) | | | |
| Balance at beginning of period | $49,076 | $48,949 | $49,637 | $47,852 |
| Expense provisions | 1,737 | 1,775 | 3,047 | 3,302 |
| Cash payments, net of recoveries | (1,450 ) | (2,890 ) | (3,321 ) | (3,320 ) |
| Balance at end of period | $49,363 | $47,834 | $49,363 | $47,834 |

In the ordinary course of business, we make payments from our insurance reserves to settle litigation claims arising primarily from our homebuilding activities. These payments are irregular in both their timing and their magnitude. As a result, the cash payments, net of recoveries shown for the three and six months ended June 30, 2014 and 2013 are not necessarily indicative of what future cash payments will be for subsequent periods.

**13. Deferred Compensation Retirement Plans**

Effective August 1, 2008, the Company entered into amended and restated employment agreements (as amended on March 8, 2012, the “Employment Agreements”) with Larry A. Mizel, Chairman of the Board and Chief Executive Officer, and David D. Mandarich, President and Chief Operating Officer (collectively, the “Executive Officers”), which provided certain annual post-retirement pension benefits (the “Retirement Benefits”) depending on the year of retirement. In response to concerns expressed by significant institutional investors, and in accordance with the recommendation of an independent compensation consultant to the Company’s Compensation Committee, the Company announced that it had reached agreements (collectively, the “Second Amendments”) with the Executive Officers for the early termination, effective on October 18, 2013, of the Retirement Benefits contained in their respective Employment Agreements. Pursuant to the Second Amendments, the Company will pay each of Mr. Mizel and Mr. Mandarich a deferred lump sum in the amount of $14.8 million and $16.0 million, respectively, in full satisfaction of their past, present and future Retirement Benefits. The Company’s termination of the Retirement Benefits is irrevocable. These payments, which equal the amounts accrued on the books of the Company as of June 30, 2013 with respect to the Company’s estimated liability to pay Retirement Benefits, will be made to the Executive Officers on October 20, 2014. As a result of the termination of the Retirement Benefits, the Company no longer accrues additional expenses relating to Retirement Benefits.

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## 14. Income Taxes

At the end of each interim period, we are required to estimate our annual effective tax rate for the fiscal year and use that rate to provide for income taxes for the current year-to-date reporting period. As a result, we recorded income tax expense of $12.5 million and $19.6 million for the three and six months ended June 30, 2014, respectively, compared to a benefit of $186.9 million and $186.8 million for the same respective periods in 2013. Our overall effective income tax rates were 36.7% and 37.3% for the three and six months ended June 30, 2014, respectively, while our effective tax rates for the same periods in 2013 were not meaningful as the income tax benefit was not directly correlated to the amount of pretax income in such periods due to a $187.6 million benefit from the reversal of our deferred tax asset valuation allowance in the 2013 second quarter.

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

| | June 30, 2014 | December 31, 2013 |
|---|---|---|
| | (Dollars in thousands) | |
| Deferred tax assets: | | |
| Federal net operating loss carryforwards | $60,887 | $70,770 |
| State net operating loss carryforwards | 41,625 | 40,012 |
| Alternative minimum tax and other tax credit carryforwards | 24,772 | 24,196 |
| Stock-based compensation expense | 25,923 | 26,651 |
| Warranty, litigation and other reserves | 14,186 | 15,543 |
| Receivables from related party | 12,081 | 12,132 |
| Deferred compensation retirement plans and accrued compensation | 4,313 | 11,136 |
| Asset impairment charges | 4,099 | 5,496 |
| Inventory, additional costs capitalized for tax purposes | 1,914 | 1,700 |
| Other, net | 4,070 | 3,446 |
| Total deferred tax assets | 193,870 | 211,082 |
| Valuation allowance | (14,988 ) | (14,669 ) |
| Total deferred tax assets, net of valuation allowance | 178,882 | 196,413 |
| | | |
| Deferred tax liabilities: | | |
| Property, equipment and other assets | 5,242 | 5,512 |

| | | |
|---|---|---|
| Discount on notes receivable | 4,204 | 4,204 |
| Deferred revenue | 3,715 | 3,985 |
| Unrealized gain on marketable securities | 3,388 | 4,915 |
| Other, net | 1,461 | 1,535 |
| Total deferred tax liabilities | 18,010 | 20,151 |
| Net deferred tax asset | $160,872 | $176,262 |

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**Notes to Unaudited Consolidated Financial Statements**

**15. Senior Notes**

The following table sets forth the carrying amount of our senior notes as of June 30, 2014 and December 31, 2013, net of applicable discounts:

| | June 30, 2014 | December 31, 2013 |
|---|---|---|
| | (Dollars in thousands) | |
| 5 % Senior Notes due December 2014, net | $- | $249,814 |
| 5 % Senior Notes due July 2015, net | 249,956 | 249,935 |
| 5 % Senior Notes due February 2020, net | 246,156 | 245,871 |
| 5½% Senior Notes due January 2024, net | 250,000 | - |
| 6% Senior Notes due January 2043 | 350,000 | 350,000 |
| Total | $1,096,112 | $1,095,620 |

On January 15, 2014, we issued $250 million of 5½% Senior Notes due 2024 (the "5½% Notes"). The 5½% Notes, which pay interest semi-annually in arrears on January 15 and July 15 of each year, with payments commencing July 15, 2014, are general unsecured obligations of MDC and rank equally and ratably with our other general unsecured and unsubordinated indebtedness. We received proceeds of $248.4 million, net of underwriting fees of $1.6 million.

During the first quarter 2014, we redeemed our 5 % Senior Notes due December 2014. As a result of this transaction, we paid $259.1 million to extinguish $250 million in debt principal with a carrying value, including unamortized deferred financing costs, of $249.7 million and recorded a $9.4 million expense for loss on extinguishment of debt.

Our senior notes are not secured and, while the senior note indentures contain some restrictions on secured debt and other transactions, they do not contain financial covenants. Our senior notes are fully and unconditionally guaranteed on an unsecured basis, jointly and severally, by substantially all of our homebuilding segment subsidiaries.

**16. Stock Based Compensation**

We account for share-based awards in accordance with ASC 718, *Compensation-Stock Compensation*, which requires the fair value of stock-based compensation awards to be amortized as an expense over the vesting period. Stock-based compensation awards are valued at fair value on the date of grant.

During the three and six months ended June 30, 2014, we expensed $0.6 million and $1.2 million, respectively, for stock option grants, compared to $0.8 million and $2.8 million, respectively, during the same periods in 2013. We expensed $0.6 million and $1.3 million for restricted stock awards during the three and six months ended June 30, 2014, respectively, compared to $1.0 million and $2.4 million, respectively, during the same periods in 2013.

**17. Commitments and Contingencies**

*Surety Bonds and Letters of Credit.* We are required to obtain surety bonds and letters of credit in support of our obligations for land development and subdivision improvements, homeowner association dues, warranty work, contractor license fees and earnest money deposits. At June 30, 2014, we had issued and outstanding surety bonds and letters of credit totaling $116.5 million and $37.2 million, respectively, including $21.2 million in letters of credit issued by HomeAmerican. The estimated cost to complete obligations related to these bonds and letters of credit was approximately $47.1 million and $7.1 million, respectively. The letters of credit as of June 30, 2014, excluding those issued by HomeAmerican, were outstanding under our unsecured revolving credit facility (see Note 19 for further discussion of the revolving credit facility). We expect that the obligations secured by these performance bonds and letters of credit generally will be performed in the ordinary course of business and in accordance with the applicable contractual terms. To the extent that the obligations are performed, the related performance bonds and letters of credit should be released and we should not have any continuing obligations. However, in the event any such performance bonds or letters of credit are called, our indemnity obligations could require us to reimburse the issuer of the performance bond or letter of credit.

We have made no material guarantees with respect to third-party obligations.

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*Mortgage Loan Loss Reserves.* In the normal course of business, we establish reserves for potential losses associated with HomeAmerican’s sale of mortgage loans to third-parties. These reserves are created to address repurchase and indemnity claims by third-party purchasers of the mortgage loans, which claims arise primarily out of allegations of homebuyer fraud at the time of origination of the loan. These reserves are based upon, among other matters: (1) pending claims received from third-party purchasers associated with previously sold mortgage loans; (2) a current assessment of the potential exposure associated with future claims of homebuyer fraud in mortgage loans originated in prior periods; and (3) historical loss experience. In addition to reserves established for mortgage loans previously sold to third-parties, we establish reserves for loans that we have repurchased if we believe the loss is likely and estimable. Our mortgage loan reserves are reflected as a component of accrued liabilities in the financial services section of the accompanying consolidated balance sheets, and the associated expenses are included in expenses in the financial services section of the accompanying consolidated statements of operations.

The following table summarizes the mortgage loan loss reserve activity.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | (Dollars in thousands) | | | |
| Balance at beginning of period | $873 | $1,140 | $1,370 | $976 |
| Expense provisions | - | 378 | - | 628 |
| Cash payments | - | (70) | - | (156) |
| Adjustments | (159) | (98) | (656) | (98) |
| Balance at end of period | $714 | $1,350 | $714 | $1,350 |

*Legal Reserves.* Because of the nature of the homebuilding business, we have been named as defendants in various claims, complaints and other legal actions arising in the ordinary course of business, including product liability claims and claims associated with the sale and financing of homes. In the opinion of management, the outcome of these ordinary course matters will not have a material adverse effect upon our financial condition, results of operations or cash flows.

*Lot Option Contracts*. In the normal course of business, we enter into lot option purchase contracts (“Option Contracts”), generally through a deposit of cash or a letter of credit, for the right to purchase land or lots at a future point in time with predetermined terms. The use of such land option and other contracts generally allow us to reduce the risks associated with direct land ownership and development, reduces our capital and financial commitments, and minimizes the amount of our land inventories on our consolidated balance sheets. Our obligation with respect to Option Contracts is generally limited to forfeiture of the related deposits. At June 30, 2014, we had cash deposits and letters of credit totaling $16.6 million and $3.4 million, respectively, at risk associated with the option to purchase 3,305 lots.

**18. Derivative Financial Instruments**

The derivative instruments we utilize in the normal course of business are interest rate lock commitments and forward sales of mortgage-backed securities, both of which typically are short-term in nature. Forward sales of mortgage-backed securities are utilized to hedge changes in fair value of our interest rate lock commitments as well as mortgage loans held-for-sale not under commitments to sell. For forward sales of securities, as well as interest rate lock commitments that are still outstanding at the end of a reporting period, we record the changes in fair value of the derivatives in revenues in the financial services section of our consolidated statements of operations with an offset to prepaid expenses and other assets or accounts payable and accrued liabilities in the financial services section of our accompanying consolidated balance sheets, depending on the nature of the change.

At June 30, 2014, we had interest rate lock commitments with an aggregate principal balance of $79.6 million. Additionally, we had $9.5 million of mortgage loans held-for-sale that were not under commitments to sell at June 30, 2014. In order to hedge the changes in fair value of our interest rate lock commitments and mortgage loans held-for-sale which had not yet been committed to a mortgage purchaser, we had forward sales of securities totaling $56.0 million at June 30, 2014.

For the three and six months ended June 30, 2014, we recorded net gains (losses) on our derivatives of $0.1 million and $(0.4) million, respectively, compared to $0.6 million and $1.4 million for the same periods in 2013.

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**19. Lines of Credit**

*Revolving Credit Facility.* On December 13, 2013, we entered into an unsecured revolving credit facility ("Revolving Credit Facility") with a group of lenders which may be used for general corporate purposes. Our Revolving Credit Facility has an aggregate commitment amount of $450 million (the "Commitment") and a maturity date of December 13, 2018. Each lender may issue letters of credit in an amount up to 50% of its commitment. The facility permits an increase in the maximum Commitment amount to $1.0 billion upon our request, subject to receipt of additional commitments from existing or additional lenders. Interest rates on outstanding borrowings are determined by reference to a specified London Interbank Offered Rate (LIBOR), a specified federal funds effective rate or a specified prime rate, plus a margin that is determined based on our credit ratings and leverage ratio, as defined in the facility agreement. At any time at which our leverage ratio, as of the last day of the most recent calendar quarter, exceeds 55%, the aggregate principal amount of all consolidated senior debt borrowings outstanding may not exceed the borrowing base. There is no borrowing base requirement if our leverage ratio, as of the last day of the most recent calendar quarter, is 55% or less.

The Revolving Credit Facility is fully and unconditionally guaranteed, jointly and severally, by most of our homebuilding segment subsidiaries. The facility contains various representations, warranties and covenants that we believe are customary for agreements of this type. The financial covenants include a consolidated tangible net worth test and a leverage test, along with a consolidated tangible net worth covenant, all as defined in the facility agreement. A failure to satisfy the foregoing tests does not constitute an event of default, but can trigger a "term-out" of the facility. A breach of the consolidated tangible net worth covenant (but not the consolidated tangible net worth test) would result in an event of default.

The Revolving Credit Facility is subject to acceleration upon certain specified events of default, including breach of the consolidated tangible net worth covenant, failure to make timely payments, breaches of certain representations or covenants, failure to pay other material indebtedness, or another person becoming beneficial owner of 50% or more of our outstanding common stock. We believe we were in compliance with the representations, warranties and covenants included in the Revolving Credit Facility as of June 30, 2014.

We incur costs associated with unused commitment fees pursuant to the terms of the Revolving Credit Facility. At June 30, 2014 and December 31, 2013, there were $16.0 million and $14.9 million, respectively, in letters of credit outstanding, which reduced the amounts available to be borrowed under the Revolving Credit Facility. As of June 30, 2014 we had $10.0 million in borrowings outstanding under the Revolving Credit Facility and no outstanding borrowings as of December 31, 2013.

*Mortgage Repurchase Facility.* HomeAmerican has a Master Repurchase Agreement, (the “Mortgage Repurchase Facility”), with U.S. Bank National Association (“USBNA”). This agreement was amended on September 20, 2013 and extended until September 19, 2014. The Mortgage Repurchase Facility provides liquidity to HomeAmerican by providing for the sale of eligible mortgage loans to USBNA with an agreement by HomeAmerican to repurchase the mortgage loans at a future date. Until such mortgage loans are transferred back to HomeAmerican, the documents relating to such loans are held by USBNA, as custodian, pursuant to the Custody Agreement (“Custody Agreement”), dated as of November 12, 2008, by and between HomeAmerican and USBNA. The Mortgage Repurchase Facility, which had a temporary increase in the maximum aggregate commitment from $50 million to $80 million from December 31, 2013 through January 30, 2014, had a maximum aggregate commitment of $50 million as of June 30, 2014. At June 30, 2014 and December 31, 2013, we had $32.2 million and $63.1 million, respectively, of mortgage loans that we were obligated to repurchase under our Mortgage Repurchase Facility. Mortgage loans that we are obligated to repurchase under the Mortgage Repurchase Facility are accounted for as a debt financing arrangement and are reported as mortgage repurchase facility in the consolidated balance sheets. Advances under the Mortgage Repurchase Facility carry a Pricing Rate equal to the greater of (i) the LIBOR Rate (as defined in the Mortgage Repurchase Facility) plus 2.75%, or (ii) 3.00%. The Mortgage Repurchase Facility contains various representations, warranties and affirmative and negative covenants that we believe are customary for agreements of this type. The negative covenants include, among others, (i) a minimum Adjusted Tangible Net Worth requirement, (ii) a maximum Adjusted Tangible Net Worth Ratio, (iii) a minimum Adjusted Net Income requirement, and (iv) a minimum Liquidity requirement. The foregoing terms are defined in the Mortgage Repurchase Facility. We believe we were in compliance with the representations, warranties and covenants included in the Mortgage Repurchase Facility as of June 30, 2014.

**M.D.C. HOLDINGS, INC.**

**Notes to Unaudited Consolidated Financial Statements**

**20. Supplemental Guarantor Information**

Our senior notes are fully and unconditionally guaranteed on an unsecured basis, jointly and severally, by the following subsidiaries (collectively, the "Guarantor Subsidiaries"), which are 100%-owned subsidiaries of the Company.

M.D.C. Land Corporation
RAH of Florida, Inc.
Richmond American Construction, Inc.
Richmond American Homes of Arizona, Inc.
Richmond American Homes of Colorado, Inc.
Richmond American Homes of Delaware, Inc.
Richmond American Homes of Florida, LP
Richmond American Homes of Illinois, Inc.
Richmond American Homes of Maryland, Inc.
Richmond American Homes of Nevada, Inc.
Richmond American Homes of New Jersey, Inc.
Richmond American Homes of Pennsylvania, Inc.
Richmond American Homes of Utah, Inc.
Richmond American Homes of Virginia, Inc.
Richmond American Homes of Washington, Inc.

The senior note indentures do not provide for a suspension of the guarantees, but do provide that any Guarantor may be released from its guarantee so long as (1) no default or event of default exists or would result from release of such guarantee, (2) the Guarantor being released has consolidated net worth of less than 5% of the Company’s consolidated net worth as of the end of the most recent fiscal quarter, (3) the Guarantors released from their guarantees in any year-end period comprise in the aggregate less than 10% (or 15% if and to the extent necessary to permit the cure of a default) of the Company’s consolidated net worth as of the end of the most recent fiscal quarter, (4) such release would not have a material adverse effect on the homebuilding business of the Company and its subsidiaries and (5) the Guarantor is released from its guarantee(s) under all Specified Indebtedness (other than by reason of payment under its guarantee of Specified Indebtedness). Upon delivery of an officers’ certificate and an opinion of counsel stating that all conditions precedent provided for in the indenture relating to such transactions have been complied with and the release is authorized, the guarantee will be automatically and unconditionally released. “Specified Indebtedness” means indebtedness under the senior notes, the Company’s Indenture dated as of December 3, 2002, the Revolving Credit Facility, and any refinancing, extension, renewal or replacement of any of the foregoing.

We have determined that separate, full financial statements of the Guarantor Subsidiaries would not be material to investors and, accordingly, supplemental financial information for the Guarantor and Non-Guarantor Subsidiaries is presented below.

**M.D.C. HOLDINGS, INC.**

**Notes to Unaudited Consolidated Financial Statements**

**Supplemental Condensed Combining Balance Sheet**

| | June 30, 2014 | | | | |
|---|---|---|---|---|---|
| | MDC | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminating Entries | Consolidated MDC |
| | Dollars in thousands | | | | |
| **ASSETS** | | | | | |
| **Homebuilding:** | | | | | |
| Cash and cash equivalents | $97,014 | $3,136 | $ - | $- | $100,150 |
| Marketable securities | 492,498 | - | - | - | 492,498 |
| Restricted cash | - | 2,188 | - | - | 2,188 |
| Trade receivables | 6,707 | 22,939 | - | (2,396) | 27,250 |
| Inventories: | | | | | |
| Housing completed or under construction | - | 758,392 | - | - | 758,392 |
| Land and land under development | - | 837,889 | - | - | 837,889 |
| Total inventories | - | 1,596,281 | - | - | 1,596,281 |
| Intercompany receivables | 1,405,057 | 2,854 | 5,653 | (1,413,564) | - |
| Investment in subsidiaries | 225,275 | - | - | (225,275) | - |
| Metropolitan district bond securities (related party) | 14,291 | - | - | - | 14,291 |
| Deferred tax asset, net | 157,837 | - | - | 3,035 | 160,872 |
| Other assets, net | 40,311 | 55,828 | - | - | 96,139 |
| Total Homebuilding Assets | 2,438,990 | 1,683,226 | 5,653 | (1,638,200) | 2,489,669 |
| **Financial Services:** | | | | | |
| Cash and cash equivalents | - | - | 29,881 | - | 29,881 |
| Marketable securities | - | - | 13,390 | - | 13,390 |
| Intercompany receivables | - | - | 40,176 | (40,176) | - |
| Mortgage loans held-for-sale, net | - | - | 58,377 | - | 58,377 |
| Other assets, net | - | - | 8,279 | (3,035) | 5,244 |
| Total Financial Services Assets | - | - | 150,103 | (43,211) | 106,892 |
| Total Assets | $2,438,990 | $1,683,226 | $155,756 | $(1,681,411) | $2,596,561 |
| **LIABILITIES AND EQUITY** | | | | | |
| **Homebuilding:** | | | | | |
| Accounts payable | $- | $34,266 | $ - | $- | $34,266 |
| Accrued liabilities | 61,586 | 81,886 | 60 | 1,758 | 145,290 |

| | | | | | |
|---|---|---|---|---|---|
| Advances and notes payable to parent and subsidiaries | 48,683 | 1,378,100 | 23,786 | (1,450,569) | - |
| Revolving credit facility | 10,000 | - | - | - | 10,000 |
| Senior notes, net | 1,096,112 | - | - | - | 1,096,112 |
| Total Homebuilding Liabilities | 1,216,381 | 1,494,252 | 23,846 | (1,448,811) | 1,285,668 |
| | | | | | |
| **Financial Services:** | | | | | |
| Accounts payable and other liabilities | - | - | 60,240 | (4,154) | 56,086 |
| Advances and notes payable to parent and subsidiaries | - | - | 3,171 | (3,171) | - |
| Mortgage repurchase facility | - | - | 32,198 | - | 32,198 |
| Total Financial Services Liabilities | - | - | 95,609 | (7,325) | 88,284 |
| Total Liabilities | 1,216,381 | 1,494,252 | 119,455 | (1,456,136) | 1,373,952 |
| | | | | | |
| **Equity:** | | | | | |
| Total Stockholders' Equity | 1,222,609 | 188,974 | 36,301 | (225,275) | 1,222,609 |
| Total Liabilities and Stockholders' Equity | $2,438,990 | $1,683,226 | $ 155,756 | $(1,681,411) | $2,596,561 |

**M.D.C. HOLDINGS, INC.**

**Notes to Unaudited Consolidated Financial Statements**

**Supplemental Condensed Combining Balance Sheet**

| | December 31, 2013 | | | | |
|---|---|---|---|---|---|
| | MDC | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminating Entries | Consolidated MDC |
| | (Dollars in thousands) | | | | |
| **ASSETS** | | | | | |
| **Homebuilding:** | | | | | |
| Cash and cash equivalents | $145,180 | $3,454 | $ - | $- | $148,634 |
| Marketable securities | 569,021 | - | - | - | 569,021 |
| Restricted cash | - | 2,195 | - | - | 2,195 |
| Trade receivables | 915 | 27,951 | - | (5,459) | 23,407 |
| Inventories: | | | | | |
| Housing completed or under construction | - | 636,700 | - | - | 636,700 |
| Land and land under development | - | 774,961 | - | - | 774,961 |
| Total inventories | - | 1,411,661 | - | - | 1,411,661 |
| Intercompany receivables | 1,144,292 | 2,576 | 1,899 | (1,148,767) | - |
| Investment in subsidiaries | 335,870 | - | - | (335,870) | - |
| Deferred tax asset, net | 172,975 | - | - | 3,287 | 176,262 |
| Metropolitan district bond securities (related party) | 12,729 | - | - | - | 12,729 |
| Other assets, net | 41,204 | 43,569 | - | - | 84,773 |
| Total Homebuilding Assets | 2,422,186 | 1,491,406 | 1,899 | (1,486,809) | 2,428,682 |
| **Financial Services:** | | | | | |
| Cash and cash equivalents | - | - | 50,704 | - | 50,704 |
| Marketable securities | - | - | 19,046 | - | 19,046 |
| Intercompany receivables | - | - | 11,216 | (11,216) | - |
| Mortgage loans held-for-sale, net | - | - | 92,578 | - | 92,578 |
| Other assets, net | - | - | 7,726 | (3,287) | 4,439 |
| Total Financial Services Assets | - | - | 181,270 | (14,503) | 166,767 |
| Total Assets | $2,422,186 | $1,491,406 | $ 183,169 | $(1,501,312) | $2,595,449 |
| **LIABILITIES AND EQUITY** | | | | | |
| **Homebuilding:** | | | | | |
| Accounts payable | $13 | $15,033 | $ - | $- | $15,046 |
| Accrued liabilities | 97,612 | 56,334 | 82 | (1,207) | 152,821 |

| | | | | | |
|---|---|---|---|---|---|
| Advances and notes payable to parent and subsidiaries | 15,692 | 1,121,581 | 19,668 | (1,156,941) | - |
| Senior notes, net | 1,095,620 | - | - | - | 1,095,620 |
| Total Homebuilding Liabilities | 1,208,937 | 1,192,948 | 19,750 | (1,158,148) | 1,263,487 |
| **Financial Services:** | | | | | |
| Accounts payable and other liabilities | - | - | 59,891 | (4,252) | 55,639 |
| Advances and notes payable to parent and subsidiaries | - | - | 3,042 | (3,042) | - |
| Mortgage repurchase facility | - | - | 63,074 | - | 63,074 |
| Total Financial Services Liabilities | - | - | 126,007 | (7,294) | 118,713 |
| Total Liabilities | 1,208,937 | 1,192,948 | 145,757 | (1,165,442) | 1,382,200 |
| **Equity:** | | | | | |
| Total Stockholders' Equity | 1,213,249 | 298,458 | 37,412 | (335,870) | 1,213,249 |
| Total Liabilities and Stockholders' Equity | $2,422,186 | $1,491,406 | $ 183,169 | $(1,501,312) | $ 2,595,449 |

**M.D.C. HOLDINGS, INC.**

**Notes to Unaudited Consolidated Financial Statements**

**Supplemental Condensed Combining Statement of Operations**

| | Three Months Ended June 30, 2014 | | | | |
|---|---|---|---|---|---|
| | MDC | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminating Entries | Consolidated MDC |
| **Homebuilding:** | (Dollars in thousands) | | | | |
| Revenues | $ - | $ 431,261 | $ - | $ - | $ 431,261 |
| Cost of Sales | - | (356,697) | - | - | (356,697) |
| Inventory impairments | - | (850) | - | - | (850) |
| Gross margin | - | 73,714 | - | - | 73,714 |
| Selling, general, and administrative expenses | (10,644) | (38,977) | - | (177) | (49,798) |
| Equity income of subsidiaries | 25,679 | - | - | (25,679) | - |
| Interest and other income | 4,114 | 506 | 6 | (13) | 4,613 |
| Interest expense | - | - | - | - | - |
| Other expense | (2) | (1,078) | - | - | (1,080) |
| Loss on early extinguishment of debt | - | - | - | - | - |
| Homebuilding pretax income (loss) | 19,147 | 34,165 | 6 | (25,869) | 27,449 |
| **Financial Services:** | | | | | |
| Financial services pretax income | - | - | 6,387 | 190 | 6,577 |
| Income before income taxes | 19,147 | 34,165 | 6,393 | (25,679) | 34,026 |
| (Provision) benefit for income taxes | 2,395 | (12,494) | (2,385) | - | (12,484) |
| Net income | $ 21,542 | $ 21,671 | $ 4,008 | $ (25,679) | $ 21,542 |
| Other comprehensive income related to available for sale securities, net of tax | 2,327 | - | 53 | (53) | 2,327 |
| Comprehensive income | $ 23,869 | $ 21,671 | $ 4,061 | $ (25,732) | $ 23,869 |

| | Three Months Ended June 30, 2013 | | | | |
|---|---|---|---|---|---|
| | MDC | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminating Entries | Consolidated MDC |
| **Homebuilding:** | (Dollars in thousands) | | | | |
| Revenues | $ - | $ 402,134 | $ - | $ - | $ 402,134 |
| Cost of Sales | - | (329,362) | - | - | (329,362) |
| Inventory impairments | - | - | - | - | - |
| Gross margin | - | 72,772 | - | - | 72,772 |
| Selling, general, and administrative expenses | (14,517) | (37,299) | (3) | (89) | (51,908) |
| Equity income of subsidiaries | 39,829 | - | - | (39,829) | - |
| Interest and other income | 9,864 | 336 | - | - | 10,200 |

| | | | | | |
|---|---|---|---|---|---|
| Interest expense | (909 ) | - | - | - | (909 ) |
| Other expense | (5 ) | (361 ) | - | - | (366 ) |
| Loss on early extinguishment of debt | - | - | - | - | - |
| Homebuilding pretax income (loss) | 34,262 | 35,448 | (3 ) | (39,918 ) | 29,789 |
| **Financial Services:** | | | | | |
| Financial services pretax income | - | - | 8,134 | 89 | 8,223 |
| Income before income taxes | 34,262 | 35,448 | 8,131 | (39,829 ) | 38,012 |
| (Provision) benefit for income taxes | 190,647 | (748 ) | (3,002 ) | - | 186,897 |
| Net income | $ 224,909 | $ 34,700 | $ 5,129 | $ (39,829 ) | $ 224,909 |
| Other comprehensive income related to available for sale securities, net of tax | (1,995 ) | - | (196 ) | 196 | (1,995 ) |
| Comprehensive income | $ 222,914 | $ 34,700 | $ 4,933 | $ (39,633 ) | $ 222,914 |

**M.D.C. HOLDINGS, INC.**

**Notes to Unaudited Consolidated Financial Statements**

**Supplemental Condensed Combining Statement of Operations**

| | Six Months Ended June 30, 2014 | | | | |
|---|---|---|---|---|---|
| | MDC | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminating Entries | Consolidated MDC |
| **Homebuilding:** | (Dollars in thousands) | | | | |
| Revenues | $- | $ 749,795 | $ - | $ - | $ 749,795 |
| Cost of Sales | - | (616,175 ) | - | - | (616,175 ) |
| Inventory impairments | - | (850 ) | - | - | (850 ) |
| Gross margin | - | 132,770 | - | - | 132,770 |
| Selling, general, and administrative expenses | (22,721 ) | (75,087 ) | - | (332 ) | (98,140 ) |
| Equity income of subsidiaries | 42,752 | - | - | (42,752 ) | - |
| Interest and other income | 17,341 | 835 | 9 | (23 ) | 18,162 |
| Interest expense | (685 ) | - | - | - | (685 ) |
| Other expense | (4 ) | (1,689 ) | - | - | (1,693 ) |
| Loss on early extinguishment of debt | (9,412 ) | - | - | - | (9,412 ) |
| Homebuilding pretax income (loss) | 27,271 | 56,829 | 9 | (43,107 ) | 41,002 |
| **Financial Services:** | | | | | |
| Financial services pretax income | - | - | 11,309 | 355 | 11,664 |
| Income before income taxes | 27,271 | 56,829 | 11,318 | (42,752 ) | 52,666 |
| (Provision) benefit for income taxes | 5,775 | (21,171 ) | (4,224 ) | - | (19,620 ) |
| Net income | $33,046 | $ 35,658 | $ 7,094 | $ (42,752 ) | $ 33,046 |
| Other comprehensive income related to available for sale securities, net of tax | (1,719 ) | - | 115 | (115 ) | (1,719 ) |
| Comprehensive income | $31,327 | $ 35,658 | $ 7,209 | $ (42,867 ) | $ 31,327 |

| | Six Months Ended June 30, 2013 | | | | |
|---|---|---|---|---|---|
| | MDC | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminating Entries | Consolidated MDC |
| **Homebuilding:** | | | | | |
| Revenues | $- | $ 735,130 | $ - | $ (1,248 ) | $ 733,882 |
| Cost of Sales | - | (604,686 ) | - | 1,248 | (603,438 ) |
| Inventory impairments | - | - | - | - | - |
| Gross margin | - | 130,444 | - | - | 130,444 |
| Selling, general, and administrative expenses | (30,096 ) | (69,845 ) | (3 ) | (165 ) | (100,109 ) |
| Equity income of subsidiaries | 69,658 | - | - | (69,658 ) | - |
| Interest and other income | 16,057 | 692 | - | - | 16,749 |

| | | | | | |
|---|---|---|---|---|---|
| Interest expense | (1,726) | - | - | - | (1,726) |
| Other expense | (8) | (714) | - | - | (722) |
| Loss on early extinguishment of debt | - | - | - | - | - |
| Homebuilding pretax income (loss) | 53,885 | 60,577 | (3) | (69,823) | 44,636 |
| **Financial Services:** | | | | | |
| Financial services pretax income | - | - | 15,797 | 165 | 15,962 |
| Income before income taxes | 53,885 | 60,577 | 15,794 | (69,658) | 60,598 |
| (Provision) benefit for income taxes | 193,540 | (826) | (5,887) | - | 186,827 |
| Net income | $ 247,425 | $ 59,751 | $ 9,907 | $ (69,658) | $ 247,425 |
| Other comprehensive income related to available for sale securities, net of tax | 540 | - | (292) | 292 | 540 |
| Comprehensive income | $ 247,965 | $ 59,751 | $ 9,615 | $ (69,366) | $ 247,965 |

**M.D.C. HOLDINGS, INC.**

**Notes to Unaudited Consolidated Financial Statements**

**Supplemental Condensed Combining Statement of Cash Flows**

| | Six Months Ended June 30, 2014 | | | | |
|---|---|---|---|---|---|
| | MDC | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminating Entries | Consolidated MDC |
| | (Dollars in thousands) | | | | |
| Net cash provided by (used in) operating activities | $(26,472) | $(110,958) | $41,158 | $- | $(96,272) |
| Net cash used in investing activities | 3,390 | (223) | 5,664 | 74,094 | 82,925 |
| Financing activities: | | | | | |
| Payments from (advances to) subsidiaries | - | 110,863 | (36,769) | (74,094) | - |
| Advances on mortgage repurchase facility, net | - | - | (30,876) | - | (30,876) |
| Proceeds from issuance of senior notes | 248,375 | - | - | - | 248,375 |
| Repayment of senior notes | (259,118) | - | - | - | (259,118) |
| Advances on revolving credit facility, net | 10,000 | - | - | - | 10,000 |
| Dividend payments | (24,412) | - | - | - | (24,412) |
| Proceeds from exercise of stock options | 71 | - | - | - | 71 |
| Net cash provided by (used in) financing activities | (25,084) | 110,863 | (67,645) | (74,094) | (55,960) |
| Net increase in cash and cash equivalents | (48,166) | (318) | (20,823) | - | (69,307) |
| Cash and cash equivalents: | | | | | |
| Beginning of period | 145,180 | 3,454 | 50,704 | - | 199,338 |
| End of period | $97,014 | $3,136 | $29,881 | $- | $130,031 |

| | Six Months Ended June 30, 2013 | | | | |
|---|---|---|---|---|---|
| | MDC | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminating Entries | Consolidated MDC |
| | (Dollars in thousands) | | | | |
| Net cash provided by (used in) operating activities | $14,053 | $(261,545) | $101,249 | $- | $(146,243) |
| Net cash used in investing activities | (287,067) | (629) | 8,038 | 190,647 | (89,011) |
| Financing activities: | | | | | |
| Payments from (advances to) subsidiaries | - | 262,803 | (72,156) | (190,647) | - |
| Mortgage repurchase facility | - | - | (27,479) | - | (27,479) |
| Proceeds from the issuance of senior notes | 346,938 | - | - | - | 346,938 |
| Proceeds from exercise of stock options | 5,118 | - | - | - | 5,118 |

| | | | | | |
|---|---|---|---|---|---|
| Net cash provided by (used in) financing activities | 352,056 | 262,803 | (99,635 ) | (190,647 ) | 324,577 |
| Net increase (decrease) in cash and cash equivalents | 79,042 | 629 | 9,652 | - | 89,323 |
| Cash and cash equivalents: | | | | | |
| Beginning of period | 125,904 | 3,308 | 30,883 | - | 160,095 |
| End of period | $204,946 | $ 3,937 | $ 40,535 | $ - | $ 249,418 |

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

*The following discussion should be read in conjunction with, and is qualified in its entirety by, the Unaudited Consolidated Financial Statements and Notes thereto included elsewhere in this Quarterly Report on Form 10-Q. This item contains forward-looking statements that involve risks and uncertainties. Actual results may differ materially from those indicated in such forward-looking statements. Factors that may cause such a difference include, but are not limited to, those discussed in "Item 1A: Risk Factors" of our Annual Report on Form 10-K for the year ended December 31, 2013 and this Quarterly Report on Form 10-Q.*

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | (Dollars in thousands, except per share amounts) | | | |
| **Homebuilding:** | | | | |
| Home sale revenues | $430,743 | $400,327 | $749,277 | $732,075 |
| Land sale revenues | 518 | 1,807 | 518 | 1,807 |
| Total home and land sale revenues | 431,261 | 402,134 | 749,795 | 733,882 |
| Home cost of sales | (356,175) | (327,927) | (615,653) | (602,003) |
| Land cost of sales | (522) | (1,435) | (522) | (1,435) |
| Inventory impairments | (850) | - | (850) | - |
| Total cost of sales | (357,547) | (329,362) | (617,025) | (603,438) |
| Gross margin | 73,714 | 72,772 | 132,770 | 130,444 |
| Gross margin % | 17.1% | 18.1% | 17.7% | 17.8% |
| Selling, general and administrative expenses | (49,798) | (51,908) | (98,140) | (100,109) |
| Interest and other income | 4,613 | 10,200 | 18,162 | 16,749 |
| Interest expense | - | (909) | (685) | (1,726) |
| Other expense | (1,080) | (366) | (1,693) | (722) |
| Loss on early extinguishment of debt | - | - | (9,412) | - |
| Homebuilding pretax income | 27,449 | 29,789 | 41,002 | 44,636 |
| | | | | |
| **Financial Services:** | | | | |
| Revenues | 11,491 | 13,884 | 20,714 | 26,390 |
| Expenses | (5,615) | (6,581) | (10,539) | (12,223) |
| Interest and other income | 701 | 920 | 1,489 | 1,795 |
| Financial services pretax income | 6,577 | 8,223 | 11,664 | 15,962 |
| | | | | |
| Income before income taxes | 34,026 | 38,012 | 52,666 | 60,598 |
| Benefit from (provision for) income taxes | (12,484) | 186,897 | (19,620) | 186,827 |
| Net income | $21,542 | $224,909 | $33,046 | $247,425 |
| | | | | |
| Earnings per share: | | | | |
| Basic | $0.44 | $4.60 | $0.68 | $5.06 |

| | | | | |
|---|---|---|---|---|
| Diluted | $0.44 | $4.55 | $0.67 | $5.01 |
| | | | | |
| Weighted average common shares outstanding: | | | | |
| Basic | 48,640,979 | 48,478,076 | 48,613,521 | 48,410,486 |
| Diluted | 48,852,696 | 48,946,055 | 48,842,527 | 48,916,988 |
| | | | | |
| Dividends declared per share | $0.25 | $- | $0.50 | $- |
| | | | | |
| Cash provided by (used in): | | | | |
| Operating Activities | $24,881 | $(90,825) | $(96,272) | $(146,243) |
| Investing Activities | $19,678 | $18,058 | $82,925 | $(89,011) |
| Financing Activities | $(9,347) | $106,505 | $(55,960) | $324,577 |

***Overview***

For both the three and six months ended June 30, 2014, our results were impacted by slower homebuilding industry conditions compared with the same periods a year ago, including more modest home price appreciation and a reduced pace of homes sales. We believe that the industry volatility we have seen is a short-term phenomenon, resulting from caution shown by many potential homebuyers, especially in the first-time buyer segment, following a significant increase in home prices in 2013 and tepid economic trends that have persisted for much of the past year. Our increased active community count, inventory management strategies and efforts to contain overhead costs have helped us partially offset the impact of the short-term decrease in overall demand as well as the lower backlog level that we had at the beginning of both the three and six month periods. Additionally, toward the end of the second quarter, we saw improvements in employment levels and consumer confidence, which supports our long-term view that the homebuilding industry should improve in the coming years.

Our net income for the 2014 second quarter was $21.5 million, or $0.44 per diluted share, compared to net income of $224.9 million, or $4.55 per diluted share, for the year earlier period. The decrease was attributable primarily to a $187.6 million benefit from the reversal of our deferred tax asset valuation allowance in the 2013 second quarter, while for the 2014 second quarter we had no such benefit and recognized $12.5 million of income tax expense. The quarter was also negatively impacted by a decline in our gross margin from home sales and a $5.6 million reduction in interest and other income, partially offset by an increase in home sale revenues and an improvement in our homebuilding selling, general and administrative ("SG&A") expenses as a percentage of home sale revenues ("SG&A rate").

For the 2014 second quarter, home sale revenues increased by $30.4 million, or 8%, year-over-year to $430.7 million, driven primarily by a 10% increase in average selling price, which was the result of price increases achieved during much of 2013, and, to a lesser extent, the geographic mix of homes delivered. Our home closings decreased only slightly for the quarter despite a 16% year-over-year decline in our beginning backlog, as we increased the number of homes that were both sold and delivered during the quarter, which was the direct result of our strategy to increase our supply of speculative homes available for quick delivery.

Our gross margin from home sales for the quarter decreased 100 basis points year-over-year to 17.1%, in large part due to higher interest in cost of sales and a $0.9 million impairment. Excluding interest in cost of sales and impairments[1], our gross margin was 21.1% for the 2014 second quarter, down 20 basis points versus 21.3% in the same quarter in 2013. In addition, cost increases, including direct construction and land costs, combined with additional incentives offered in certain markets to spur demand in a slower homebuilding environment partly offset the impact of home price increases we captured in prior periods. The decrease in our gross margin percentage, however, was more than offset by a year-over-year improvement in our SG&A rate of 140 basis points to 11.6%, resulting primarily from increases in home sale revenues, lower incentive and stock-based compensation expenses, and lower legal expenses.

For the 2014 second quarter, we experienced our first year-over-year increase in net new orders since the first quarter of 2013. The dollar value of net new orders increased by $59.3 million, or 12%, year-over-year, to $544.8 million for the 2014 second quarter. The increase was driven by both a 5% increase in the number of net new orders, resulting from an 11% increase in average active communities to 158 for the 2014 second quarter, and a 7% increase in average selling price.

For the six months ended June 30, 2014, our net income was $33.0 million, or $0.67 per diluted share, compared to net income of $247.4 million, or $5.01 per diluted share, for the year earlier period. The decrease was attributable primarily to the $187.6 million benefit from the reversal of our deferred tax asset valuation allowance in the 2013 second quarter, while for the six months ended June 30, 2014 we had no such benefit and recognized $19.6 million of income tax expense. The six month period for 2014 was also adversely impacted by a $9.4 million charge related to the early extinguishment of debt recognized in the 2014 first quarter and a 27% decline in financial services income due primarily to more competitive mortgage market conditions and higher interest rates, which was partially offset by a 60 basis point decrease in our SG&A rate.

We increased inventories by $184.6 million since the beginning of the year, including the purchase of nearly 1,150 lots in 38 communities during the 2014 second quarter, resulting in a 13% year-over-year increase in the total supply of lots owned and under option at June 30, 2014. The investment in inventories was funded using our cash and marketable securities. Including amounts available under our $450 million revolving credit facility, we ended the second quarter with total liquidity of approximately $1.1 billion, up 20% over the prior year. We believe that this level of liquidity provides the appropriate balance for us between supporting potential growth opportunities and providing protection from the volatile and cyclical nature of the housing market.

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[1] See reconciliation of non-GAAP measures in the Gross Margin section below.

***Homebuilding***

*Pretax Income*

| | Three Months Ended | | | | Six Months Ended | | | |
|---|---|---|---|---|---|---|---|---|
| | June 30, | | Change | | June 30, | | Change | |
| | 2014 | 2013 | Amount | % | 2014 | 2013 | Amount | % |
| | (Dollars in thousands) | | | | | | | |
| West | $16,695 | $16,779 | $(84 ) | (1) % | $29,345 | $27,390 | $1,955 | 7 % |
| Mountain | 12,182 | 14,142 | (1,960) | (14)% | 19,541 | 27,138 | (7,597) | (28)% |
| East | 5,296 | 4,523 | 773 | 17 % | 7,957 | 6,051 | | |