

INCOME OPPORTUNITY REALTY INVESTORS INC /TX/

Form 10-Q

November 14, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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

For the quarterly period ended September 30, 2017

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 001-14784

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**INCOME OPPORTUNITY REALTY INVESTORS, INC.**

**(Exact Name of Registrant as Specified in Its Charter)**

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Nevada 75-2615944  
(State or Other Jurisdiction of (I.R.S. Employer

Incorporation or Organization) Identification No.)

1603 Lyndon B. Johnson Freeway, Suite 800, Dallas, Texas 75234

(Address of principal executive offices)

(Zip Code)

(469) 522-4200

(Registrant's telephone number, including area code)

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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, a non-accelerated filer or a smaller reporting company. See definitions 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 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

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

Common Stock, \$.01 par value	4,168,214
(Class)	(Outstanding at November 14, 2017)

**INCOME OPPORTUNITY REALTY INVESTORS, INC.**

**FORM 10-Q**

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**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****INCOME OPPORTUNITY REALTY INVESTORS, INC.****CONSOLIDATED BALANCE SHEETS****(Unaudited)**

	September 30, 2017	December 31, 2016
	<b>(dollars in thousands, except par value amount)</b>	
Assets		
Real estate land holdings subject to sales contract, at cost	\$22,717	\$ 22,717
Total real estate	22,717	22,717
Notes and interest receivable from related parties	15,403	25,485
Less allowance for doubtful accounts	(1,826 )	(1,826 )
Total notes and interest receivable	13,577	23,659
Cash and cash equivalents	4	1
Receivable and accrued interest from related parties	50,391	37,768
Other assets	2,049	2,257
Total assets	\$88,738	\$ 86,402
Liabilities and Shareholders' Equity		
Liabilities:		
Accounts payable and other liabilities	\$—	\$ 23
Total liabilities	—	23
Shareholders' equity:		
Common stock, \$0.01 par value, authorized 10,000,000 shares; issued 4,173,675 and outstanding 4,168,214 shares in 2017 and 2016	42	42
Treasury stock at cost, 5,461 shares in 2017 and 2016	(39 )	(39 )
Paid-in capital	61,955	61,955
Retained earnings	26,780	24,421
Total shareholders' equity	88,738	86,379

Total liabilities and shareholders' equity	\$88,738	\$ 86,402
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The accompanying notes are an integral part of these consolidated financial statements.

## INCOME OPPORTUNITY REALTY INVESTORS, INC.

## CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
	(dollars in thousands, except per share amounts)			
Revenues:				
Rental and other property revenues	\$—	\$—	\$—	\$—
Expenses:				
General and administrative (including \$63 and \$47 for the three months and \$174 and \$127 for the nine months ended 2017 and 2016, respectively, from related parties)	93	114	342	333
Net income fee to related party	53	67	189	193
Advisory fee to related party	166	162	493	475
Total operating expenses	312	343	1,024	1,001
Net operating loss	(312)	(343)	(1,024)	(1,001)
Other income:				
Interest income from related parties	924	1,095	3,133	3,389
Other Income	—	—	250	—
Total other income	924	1,095	3,383	3,389
Net income	\$612	\$752	\$2,359	\$2,388
Earnings per share - basic and diluted				
Net income	\$0.15	\$0.18	\$0.57	\$0.57
Weighted average common shares used in computing earnings per share				
	4,168,214	4,168,214	4,168,214	4,168,214

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

INCOME OPPORTUNITY REALTY INVESTORS, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

For the Nine Months Ended September 30, 2017

(dollars in thousands)

(Unaudited)

	Total	Common Stock Shares	Common Stock Amount	Treasury Stock	Paid-in Capital	Retained Earnings
Balance, December 31, 2016	\$86,379	4,173,675	\$ 42	\$ (39 )	\$61,955	\$24,421
Net income	2,359	—	—	—	—	2,359
Balance, September 30, 2017	\$88,738	4,173,675	\$ 42	\$ (39 )	\$61,955	\$26,780

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



## INCOME OPPORTUNITY REALTY INVESTORS, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	For the Nine Months Ended September 30,	
	2017	2016
	(dollars in thousands)	
Cash Flow From Operating Activities:		
Net income	\$2,359	\$2,388
Adjustments to reconcile net income to net cash provided by operating activities:		
Decrease in assets:		
Notes and accrued interest receivable from related parties	10,082	1,951
Other assets	208	133
Decrease in other liabilities	(23 )	—
Net cash provided by operating activities	12,626	4,472
Cash Flow From Investing Activities:		
Related party receivables	(12,623)	(4,473)
Net cash used in investing activities	(12,623)	(4,473)
Cash Flow From Financing Activities:		
Payments on notes payable to related parties	—	—
Net cash used in financing activities	—	—
Net change in cash and cash equivalents	3	(1 )
Cash and cash equivalents, beginning of period	1	2
Cash and cash equivalents, end of period	\$4	\$1

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 1. ORGANIZATION AND BASIS OF PRESENTATION

#### Organization

As used herein, the terms “IOR”, “the Company”, “we”, “our”, “us” refer to Income Opportunity Realty Investors, Inc., a Nevada corporation, individually or together with its subsidiaries. Income Opportunity Realty Investors, Inc. is the successor to a California business trust organized on December 14, 1984, which commenced operations on April 10, 1985. The Company is headquartered in Dallas, Texas, and its common stock trades on the NYSE MKT. In June 2017, the Company changed its trading symbol from (“IOT”) to (“IOR”).

Transcontinental Realty Investors, Inc. (“TCI”) owns approximately 81.1% of the Company’s common stock. Effective July 17, 2009, IOR’s financial results were consolidated with those of American Realty Investors, Inc. (“ARL”) and TCI and their subsidiaries. IOR is a “C” corporation for U.S. federal income tax purposes and files an annual consolidated income tax return with ARL and its ultimate parent, May Realty Holdings, Inc. (“MRHI”). We have no employees.

IOR invests in real estate through direct ownership, leases and partnerships and also invests in mortgage loans on real estate. Pillar Income Asset Management, Inc. (“Pillar”) is the Company’s external Advisor and Cash Manager. Although the Board of Directors is directly responsible for managing the affairs of IOR, and for setting the policies which guide it, the day-to-day operations of IOR are performed by Pillar, as the contractual Advisor, under the supervision of the Board. Pillar’s duties include, but are not limited to, locating, evaluating and recommending real estate and real estate-related investment opportunities and arranging debt and equity financing for the Company with third party lenders and investors. Additionally, Pillar serves as a consultant to the Board with regard to their decisions in connection with IOR’s business plan and investment policy. Pillar also serves as an Advisor and Cash Manager to TCI and ARL.

Our primary business is investing in real estate and mortgage receivables. Land held for development or sale is our sole operating segment. At September 30, 2017, our land consisted of 131.1 acres of developable land held subject to a sales contract. All of our land holdings are located in Farmers Branch, Texas. The principal source of revenue for the Company is interest income on approximately \$15.4 million of notes receivable due from related parties.

#### Basis of Presentation

The accompanying unaudited Consolidated Financial Statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”) have been condensed or omitted in accordance with such rules and regulations, although management believes the disclosures are adequate to prevent the information presented from being misleading. In the opinion of management, all adjustments (consisting of normal recurring matters) considered necessary for a fair presentation have been included. The results of operations for the three and nine months ended September 30, 2017, are not necessarily indicative of the results that may be expected for other interim periods or for the full fiscal year.

The year-end Consolidated Balance Sheet at December 31, 2016, was derived from the audited Consolidated Financial Statements at that date, but does not include all of the information and disclosures required by U.S. GAAP for complete financial statements. For further information, refer to the Consolidated Financial Statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2016. Certain 2016 Consolidated Financial Statement amounts have been reclassified to conform to the 2017 presentation.

### **Principles of Consolidation**

The accompanying Consolidated Financial Statements include our accounts, our subsidiaries, generally all of which are wholly-owned, and all entities in which we have a controlling interest. Arrangements that are not controlled through voting or similar rights are accounted for as a Variable Interest Entity (“VIE”), in accordance with the provisions and guidance of ASC Topic 810 “Consolidation”, whereby we have determined that we are a primary beneficiary of the VIE and meet certain criteria of a sole general partner or managing member as identified in accordance with Emerging Issues Task Force (“EITF”) Issue 04-5, Investor’s Accounting for an Investment in a Limited Partnership when the Investor is the Sole General Partner and the Limited Partners have Certain Rights (“EITF 04-5”). VIEs are generally entities that lack sufficient equity to finance their activities without additional financial support from other parties or whose equity holders as a group lack adequate decision making ability, the obligation to absorb expected losses or residual returns of the entity, or have voting rights that are not proportional to their economic interests. The primary beneficiary generally is the entity that provides financial support and bears a majority of the financial risks, authorizes certain capital transactions, or makes operating decisions that materially affect the entity’s financial results. All significant intercompany balances and transactions have been eliminated in consolidation.

In determining whether we are the primary beneficiary of a VIE, we consider qualitative and quantitative factors, including, but not limited to: the amount and characteristics of our investment; the obligation or likelihood for us or other investors to provide financial support; our and the other investors' ability to control or significantly influence key decisions for the VIE; and the similarity with and significance to the business activities of us and the other investors. Significant judgments related to these determinations include estimates about the current future fair values and performance of real estate held by these VIEs and general market conditions. As of September 30, 2017, IOR was not the primary beneficiary of a VIE.

### **Real Estate, Depreciation and Impairment**

Real estate assets are stated at the lower of depreciated cost or fair value, if deemed impaired. Major replacements and betterments are capitalized and depreciated over their estimated useful lives. Depreciation is computed on a straight-line basis over the useful lives of the properties (buildings and improvements – 10-40 years; furniture, fixtures and equipment – 5-10 years). The Company continually evaluates the recoverability of the carrying value of our real estate assets using the methodology prescribed in ASC Topic 360, "Property, Plant and Equipment". Factors considered by management in evaluating impairment of our existing real estate assets held for investment include significant declines in property operating profits, annually recurring property operating losses and other significant adverse changes in general market conditions that are considered permanent in nature. Under ASC Topic 360, a real estate asset held for investment is not considered impaired if the undiscounted, estimated future cash flows of an asset (both the annual estimated cash flow from future operations and the estimated cash flow from the theoretical sale of the asset) over its estimated holding period are in excess of the asset's net book value at the balance sheet date. If any real estate asset held for investment is considered impaired, a loss is provided to reduce the carrying value of the asset to its estimated fair value.

### **Real Estate Held For Sale**

We periodically classify real estate assets as "held for sale". An asset is classified as held for sale after the approval of our Board of Directors, after an active program to sell the asset has commenced and if the sale is probable. One of the deciding factors in determining whether a sale is probable is whether a firm purchase commitment is obtained and whether the sale is probable within the year. Upon the classification of a real estate asset as held for sale, the carrying value of the asset is reduced to the lower of its net book value or its estimated fair value, less costs to sell the asset. Subsequent to the classification of assets as held for sale, no further depreciation expense is recorded. Real estate assets held for sale are stated separately on the accompanying Consolidated Balance Sheets. Upon a decision that the sale is no longer probable, the asset is classified as an operating asset and depreciation expense is reinstated.

### **Cost Capitalization**

Costs related to planning, developing, leasing and constructing a property are capitalized and classified as Real Estate in the Consolidated Balance Sheets. We capitalize interest to qualifying assets under development based on average accumulated expenditures outstanding during the period. In capitalizing interest to qualifying assets, we first use the interest incurred on specific project debt, if any, and next use the weighted average interest rate of non-project specific debt.

We capitalize interest, real estate taxes and certain operating expenses until building construction is substantially complete and the building is ready for its intended use, but no later than one year from the cessation of major construction activity.

We capitalize leasing costs, which include commissions paid to outside brokers, legal costs incurred to negotiate and document a lease agreement and any internal costs that may be applicable. We allocate these costs to individual tenant leases and amortize them over the related lease term.

## **Fair Value Measurement**

We apply the guidance in ASC Topic 820, “Fair Value Measurements and Disclosures”, to the valuation of real estate assets. These provisions define fair value as the price that would be received to sell an asset or paid to transfer a liability in a transaction between market participants at the measurement date, establish a hierarchy that prioritizes the information used in developing fair value estimates and require disclosure of fair value measurements by level within the fair value hierarchy. The hierarchy gives the highest priority to quoted prices in active markets (Level 1 measurements) and the lowest priority to unobservable data (Level 3 measurements), such as the reporting entity’s own data.

The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date and includes three levels defined as follows:

- Level 1 – Unadjusted quoted prices for identical and unrestricted assets or liabilities in active markets.
- Level 2 – Quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3 – Unobservable inputs that are significant to the fair value measurement.

A financial instrument’s categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

## **Related Parties**

We apply ASC Topic 805, “Business Combinations”, to evaluate business relationships. Related parties are persons or entities who have one or more of the following characteristics, which include entities for which investments in their equity securities would be required, trust for the benefit of persons including principal owners of the entities and members of their immediate families, management personnel of the entity and members of their immediate families and other parties with which the entity may deal if one party controls or can significantly influence the decision making of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests, or affiliates of the entity.

## **Newly Issued Accounting Pronouncements**

In May 2014, Accounting Standards Update No. 2014-09 (“ASU 2014-09”), Revenue from Contracts with Customers, was issued. This new guidance established a new single comprehensive revenue recognition model and provides for enhanced disclosures. Under the new guidance, the nature, timing and amount of revenue recognized for certain transactions could differ from those recognized under existing accounting guidance. This new guidance does not affect revenue recognized under lease contracts. ASU 2014-09 is effective for reporting periods beginning after December 15, 2017. The Company is currently evaluating the impact of the adoption of ASU 2014-09 on its financial position and results of operations, if any.

In February 2016, FASB issued ASU 2016-02 (“ASU 2016-02”), Leases. This guidance establishes a new model for accounting for leases and provides for enhanced disclosures. ASU 2016-02 is effective for reporting periods beginning after December 15, 2018. The Company is currently evaluating the impact of the adoption of ASU 2016-02 on its financial position and results of operations, if any.

## **NOTE 2. REAL ESTATE ACTIVITY**

As of September 30, 2017, our real estate land holdings consisted of 131.1 acres of developable land, located in Farmers Branch, Texas, held subject to a sales contract. In November 2015, the Company entered into a sales contract with an unrelated party. The contract was for all of the developable land owned by the Company. In addition, TCI, ARL and Realty Advisors, Inc. (“RAI”) also sold land in this transaction. Total consideration for the sale was \$75 million. The ultimate allocation of the proceeds to the parties involved is yet to be determined and will be completed when the final use of the land, certain development commitments are completed and the noted is collected. The agreement among the parties to this transaction provides for TCI to hold the subordinated note from the buyer in the amount of \$50 million.

At the closing, the note payable to related parties for \$9.6 million was paid off. Due to the inadequate down payment from the buyer and the level of seller financing involved, the transaction is being accounted for under the deposit method. Under the deposit method, no revenue is recognized and the asset sold remains on the books until the criteria for full revenue recognition are met.

**NOTE 3. NOTES AND INTEREST RECEIVABLE FROM RELATED PARTIES**

Notes and interest receivable from related parties is comprised of junior mortgage loans, which are loans secured by mortgages that are subordinate to one or more prior liens on the underlying real estate. Recourse on the loans ordinarily includes the real estate which secures the loan, other collateral and personal guarantees of the borrower.

All of the Company's notes receivable are with Unified Housing Foundation, Inc. ("UHF"). UHF is determined to be a related party to the Company due to our significant investment in the performance of the collateral secured under the notes receivable. Payments are due from surplus cash flow from operations, sale or refinancing of the underlying properties. These notes are cross collateralized to the extent that any surplus cash available from any of the properties underlying these notes will be used to repay outstanding interest and principal for the remaining notes. Furthermore, any surplus cash available from any of the properties UHF owns, besides the properties underlying these notes, can be used to repay outstanding interest and principal for these notes. The allowance on the notes was a purchase allowance that was netted against the notes when acquired.

IOR received proceeds of \$7.1 million from the payoff of two of the notes receivable during the second quarter of 2017.

At September 30, 2017, we had mortgage loans and accrued interest receivable from related parties, net of allowances, totaling \$13.6 million. Below is a summary of notes and interest receivable from related parties (dollars in thousands):

Borrower	Maturity Date	Interest Rate	Amount	Collateral
Performing loans:				
Unified Housing Foundation, Inc. (Echo Station)	12/32	12.00 %	\$ 1,481	Secured
Unified Housing Foundation, Inc. (Lakeshore Villas)	12/32	12.00 %	2,000	Secured
Unified Housing Foundation, Inc. (Lakeshore Villas)	12/32	12.00 %	6,368	Secured
Unified Housing Foundation, Inc. (Limestone Ranch)	12/32	12.00 %	1,953	Secured
Unified Housing Foundation, Inc. (Timbers of Terrell)	12/32	12.00 %	1,323	Secured
Unified Housing Foundation, Inc. (Tivoli)	12/32	12.00 %	1,826	Secured
Accrued interest			452	
Total Performing			\$ 15,403	
Allowance for doubtful accounts			(1,826 )	
Total			\$ 13,577	



All are related party notes.

#### NOTE 4. RECEIVABLE FROM AND PAYABLE TO RELATED PARTIES

From time to time, IOR and its related parties have made unsecured advances to each other which include transactions involving the purchase, sale, and financing of property. In addition, we have a cash management agreement with our Advisor. The agreement provides for excess cash to be invested in and managed by our Advisor, Pillar, a related party. The table below reflects the various transactions between IOR, Pillar, and TCI (dollars in thousands):

	TCI	Pillar	Total
Balance, December 31, 2016	\$ 37,768	\$ —	\$ 37,768
Cash transfers	—	12,628	12,628
Advisory fees	—	(493 )	(493 )
Net income fee	—	(189 )	(189 )
Cost reimbursements	—	(174 )	(174 )
Expenses paid by advisor	—	203	203
Interest income	648	—	648
Deferred tax asset	—	—	—
Purchase of obligation	11,975	(11,975 )	—
Balance, September 30, 2017	\$ 50,391	\$ —	\$ 50,391

We have historically engaged in and will continue to engage in certain business transactions with related parties, including but not limited to asset acquisitions and dispositions. Transactions involving related parties cannot be presumed to be carried out on an arm's length basis due to the absence of free market forces that naturally exist in business dealings between two or more unrelated entities. Related party transactions may not always be favorable to our business and may include terms, conditions and agreements that are not necessarily beneficial to or in the best interest of the Company.

**NOTE 5. OPERATING SEGMENTS**

The Company's segments are based on management's method of internal reporting, which classifies operations by the type of property in the portfolio. The Company's segments by use of property are land and other. Significant differences among the accounting policies of the operating segments as compared to the Consolidated Financial Statements principally involve the calculation and allocation of administrative and other expenses. Management evaluates the performance of each of the operating segments and allocates resources to them based on their operating income and cash flow.

Other income is not reflected in the segment income. Expenses that are not reflected in the segments are advisory and net income fees, general and administrative and income taxes. The segment labeled as "Other" consists of revenue related to the notes receivable.

Presented below is the operating segment information for the three months ended September 30, 2017 and 2016 (dollars in thousands):

<u>For the Three Months Ended September 30, 2017</u>	Land	Other	Total
Operating revenues	\$—	\$—	\$—
Interest income		924	924
Segment operating income (loss)	\$—	\$924	\$924
Real estate assets	\$22,717	\$—	\$22,717
<u>For the Three Months Ended September 30, 2016</u>	Land	Other	Total
Operating revenues	\$ —	\$ —	\$ —
Interest income	—	1,095	1,095
Segment operating income (loss)	\$ —	\$ 1,095	\$ 1,095
Real estate assets	\$ 22,717	\$ —	\$ 22,717

The table below reflects the reconciliation of the segment information to the corresponding amounts in the Consolidated Statements of Operations (dollars in thousands):

For the Three  
Months Ended

	September 30,	
	2017	2016
Segment operating income	\$ 924	\$ 1,095
Other non-segment items of income (expense):		
General and administrative	(93 )	(114 )
Net income fee	(53 )	(67 )
Advisory fee to related party	(166 )	(162 )
Net income	\$ 612	\$ 752

Presented below is the operating segment information for the nine months ended September 30, 2017 and 2016 (dollars in thousands):

<u>For the Nine Months Ended September 30, 2017</u>	Land	Other	Total
Rental and other property revenues	\$—	\$—	\$—
Interest income from related parties	—	3,133	3,133
Segment operating income	\$—	\$3,133	\$3,133
Real estate assets	\$22,717	\$—	\$22,717
<u>For the Nine Months Ended September 30, 2016</u>	Land	Other	Total
Rental and other property revenues	\$—	\$—	\$—
Interest income from related parties	—	3,389	3,389
Segment operating income	\$—	\$3,389	\$3,389
Real estate assets	\$22,717	\$—	\$22,717

The table below reflects the reconciliation of the segment information to the corresponding amounts in the Consolidated Statements of Operations (dollars in thousands):

	Nine Months Ended September 30,	
	2017	2016
Segment operating income	\$ 3,133	\$ 3,389
Other non-segment items of income (expense)		
General and administrative	(342 )	(333 )
Net income fee to related party	(189 )	(193 )
Advisory fee to related party	(493 )	(475 )
Other income	250	—
Net income from continuing operations	\$ 2,359	\$ 2,388

The table below reflects the reconciliation of the segment information to the corresponding amounts in the Consolidated Balance Sheets (dollars in thousands):

	As of September 30,	
	2017	2016
Real estate assets	\$ 22,717	\$ 22,717
Notes and interest receivable	13,577	22,931

Other assets	52,444	41,044
Total assets	\$ 88,738	\$ 86,692

**NOTE 6. COMMITMENTS AND CONTINGENCIES**

*Litigation.* The Company and its subsidiaries, from time to time, have been involved in various items of litigation incidental to and in the ordinary course of its business and, in the opinion of management, the outcome of such litigation will not have a material adverse impact upon the Company's financial condition, results of operations or liquidity.

**NOTE 7. SUBSEQUENT EVENTS**

The date to which events occurring after September 30, 2017, the date of the most recent balance sheet, have been evaluated for possible adjustment to the Consolidated Financial Statements or disclosure is November 14, 2017, which is the date on which the Consolidated Financial Statements were available to be issued.

The Company has determined that there are no subsequent events to be reported.

## **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion should be read in conjunction with the financial statements and notes thereto appearing elsewhere in this report.

This Report on Form 10-Q may contain forward-looking statements within the meaning of the federal securities laws, principally, but not only, under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations." We caution investors that any forward-looking statements in this report, or which management may make orally or in writing from time to time, are based on management's beliefs and on assumptions made by, and information currently available to, management. When used, the words "anticipate", "believe", "expect", "intend", "may", "might", "plan", "estimate", "project", "should", "will", "result" and similar expressions which do not relate solely to historical matters are intended to identify forward-looking statements. These statements are subject to risks, uncertainties and assumptions and are not guarantees of future performance, which may be affected by known and unknown risks, trends, uncertainties and factors that are beyond our control. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, estimated, or projected. We caution you that, while forward-looking statements reflect our good faith beliefs when we make them, they are not guarantees of future performance and are impacted by actual events when they occur after we make such statements. We expressly disclaim any responsibility to update our forward-looking statements, whether as a result of new information, future events or otherwise. Accordingly, investors should use caution in relying on past forward-looking statements, which are based on results and trends at the time they are made, to anticipate future results or trends.

Some of the risks and uncertainties that may cause our actual results, performance, or achievements to differ materially from those expressed or implied by forward-looking statements include, among others, the following:

general risks affecting the real estate industry (including, without limitation, the inability to enter into or renew leases, dependence on tenants' financial condition, and competition from other developers, owners and operators of real estate);

risks associated with the availability and terms of construction and mortgage financing and the use of debt to fund acquisitions and developments;

demand for apartments and commercial properties in the Company's markets and the effect on occupancy and rental rates;

the Company's ability to obtain financing, enter into joint venture arrangements in relation to or self-fund the development or acquisition of properties;

risks associated with the timing and amount of property sales and the resulting gains/losses associated with such sales;

failure to manage effectively our growth and expansion into new markets or to integrate acquisitions successfully;

risks and uncertainties affecting property development and construction (including, without limitation, construction delays, cost overruns, inability to obtain necessary permits and public opposition to such activities);

risks associated with downturns in the national and local economies, increases in interest rates, and volatility in the securities markets;

costs of compliance with the Americans with Disabilities Act and other similar laws and regulations;

potential liability for uninsured losses and environmental contamination; and

risks associated with our dependence on key personnel whose continued service is not guaranteed.

The risks included here are not exhaustive. Some of the risks and uncertainties that may cause our actual results, performance, or achievements to differ materially from those expressed or implied by forward-looking statements, include among others, the factors listed and described in Part I, Item 1A. "Risk Factors" in the Company's Annual Report on Form 10-K, which investors should review. There have been no changes from the risk factors previously described in the Company's Form 10-K for the fiscal year ended December 31, 2016.

Other sections of this report may also include suggested factors that could adversely affect our business and financial performance. Moreover, we operate in a very competitive and rapidly changing environment. New risks emerge from time to time and it is not possible for management to predict all such matters; nor can we assess the impact of all such matters on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. Given these risks and uncertainties, investors should not place undue reliance on forward-looking statements as a prediction of actual results. Investors should also refer to our quarterly reports on Form 10-Q for future periods and to other materials we may furnish to the public from time to time through Forms 8-K or otherwise as we file them with the SEC.

## **Overview**

We are an externally advised and managed real estate investment company that currently owns land held for development or sale. As of September 30, 2017, we owned 131.1 developable acres of land held subject to a sales contract, located in Texas. We have no employees.

Our primary source of revenue is from the interest income on approximately \$15.4 million of notes receivable due from related parties.

We have historically engaged in, and may continue to engage in, certain business transactions with related parties, including but not limited to asset acquisition and dispositions. Transactions involving related parties cannot be presumed to be carried out on an arm's length basis due to the absence of free market forces that naturally exist in business dealings between two or more unrelated entities. Related party transactions may not always be favorable to our business and may include terms, conditions and agreements that are not necessarily beneficial to or in our best interest.

Pillar is the Company's external Advisor and Cash Manager. Although the Board of Directors is directly responsible for managing the affairs of IOR, and for setting the policies which guide it, the day-to-day operations of IOR are performed by Pillar, as the contractual Advisor, under the supervision of the Board. Pillar's duties include, but are not limited to, locating, evaluating and recommending real estate and real estate-related investment opportunities and arranging debt and equity financing for the Company with third party lenders and investors. Additionally, Pillar serves as a consultant to the Board with regard to their decisions in connection with IOR's business plan and investment policy. Pillar also serves as an Advisor and Cash Manager to TCI and ARL.

## **Critical Accounting Policies**



We present our Consolidated Financial Statements in accordance with generally accepted accounting principles in the United States of America (“U.S. GAAP”). The Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) is the single source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with U.S. GAAP.

The accompanying Consolidated Financial Statements include our accounts, our subsidiaries, generally all of which are wholly-owned, and all entities in which we have a controlling interest. Arrangements that are not controlled through voting or similar rights are accounted for as a Variable Interest Entity (“VIE”), in accordance with the provisions and guidance of ASC Topic 810 “Consolidation”, whereby we have determined that we are a primary beneficiary of the VIE and meet certain criteria of a sole general partner or managing member as identified in accordance with Emerging Issues Task Force (“EITF”) Issue 04-5, Investor’s Accounting for an Investment in a Limited Partnership when the Investor is the Sole General Partner and the Limited Partners have Certain Rights (“EITF 04-5”). VIEs are generally entities that lack sufficient equity to finance their activities without additional financial support from other parties or whose equity holders, as a group, lack adequate decision making ability, the obligation to absorb expected losses or residual returns of the entity, or have voting rights that are not proportional to their economic interests. The primary beneficiary generally is the entity that provides financial support and bears a majority of the financial risks, authorizes certain capital transactions, or makes operating decisions that materially affect the entity’s financial results. All significant intercompany balances and transactions have been eliminated in consolidation.

In determining whether we are the primary beneficiary of a VIE, we consider qualitative and quantitative factors, including, but not limited to: the amount and characteristics of our investment; the obligation or likelihood for us or other investors to provide financial support; our and the other investors’ ability to control or significantly influence key decisions for the VIE; and the similarity with and significance to the business activities of us and the other investors. Significant judgments related to these determinations include estimates about the current future fair values and performance of real estate held by these VIEs and general market conditions.

For entities in which we have less than a controlling financial interest or entities where we are not deemed to be the primary beneficiary, the entities are accounted for using the equity method of accounting. Accordingly, our share of the net earnings or losses of these entities are included in net income.

## **Real Estate**

Upon acquisitions of real estate, we assess the fair value of acquired tangible and intangible assets, including land, buildings, tenant improvements, “above-market” and “below-market” leases, origination costs, acquired in-place leases, other identified intangible assets and assumed liabilities in accordance with ASC Topic 805 “Business Combinations”, and allocate the purchase price to the acquired assets and assumed liabilities, including land at appraised value and buildings at replacement cost.

We assess and consider fair value based on estimated cash flow projections that utilize appropriate discount and/or capitalization rates, as well as available market information. Estimates of future cash flows are based on a number of factors including the historical operating results, known and anticipated trends, and market and economic conditions. The fair value of the tangible assets of an acquired property considers the value of the property as if it were vacant. We also consider an allocation of purchase price of other acquired intangibles, including acquired in-place leases that may have a customer relationship intangible value, including (but not limited to) the nature and extent of the existing relationship with the tenants, the tenants’ credit quality and expectations of lease renewals.

A variety of costs are incurred in the acquisition, development and leasing of properties. After determination is made to capitalize a cost, it is allocated to the specific component of a project that is benefited. Determination of when a development project is substantially complete and capitalization must cease involves a degree of judgment. Our capitalization policy on development properties is guided by ASC Topic 835-20 “Interest – Capitalization of Interest” and ASC Topic 970 “Real Estate – General.” The costs of land and buildings under development include specifically identifiable costs. The capitalized costs include pre-construction costs essential to the development of the property, development costs, construction costs, interest costs, real estate taxes, salaries and related costs and other costs incurred during the period of development. We cease capitalization when a building is considered substantially complete and ready for its intended use, but no later than one year from the cessation of major construction activity.

## **Depreciation and Impairment**

Real estate is stated at depreciated cost. The cost of buildings and improvements includes the purchase price of property, legal fees and other acquisition costs. Costs directly related to the development of properties are capitalized. Capitalized development costs include interest, property taxes, insurance, and other project costs incurred during the

period of development.

Management reviews its long-lived assets used in operations for impairment when there is an event or change in circumstances that indicates impairment in value. An impairment loss is recognized if the carrying amount of its assets is not recoverable and exceeds its fair value. If such impairment is present, an impairment loss is recognized based on the excess of the carrying amount of the asset over its fair value. The evaluation of anticipated cash flows is highly subjective and is based in part on assumptions regarding future occupancy, rental rates and capital requirements that could differ materially from actual results in future periods.

### **Recognition of Revenue**

Our revenues are composed largely of interest income on notes receivable recorded in accordance with the terms of the notes.

### **Revenue Recognition on the Sale of Real Estate**

Sales and the associated gains or losses of real estate assets are recognized in accordance with the provisions of ASC Topic 360-20, "Property, Plant and Equipment – Real Estate Sale." The specific timing of a sale is measured against various criteria in ASC Topic 360-20 related to the terms of the transaction and any continuing involvement in the form of management or financial assistance associated with the properties. If the sales criteria for the full accrual method are not met, we defer some or all of the gain recognition and account for the continued operations of the property by applying the finance, leasing, deposit, installment or cost recovery methods, as appropriate, until the sales criteria are met.

### **Non-Performing Notes Receivable**

We consider a note receivable to be non-performing when the maturity date has passed without principal repayment and the borrower is not making interest payments in accordance with the terms of the agreement.

### **Allowance for Estimated Losses**

We assess the collectability of notes receivable on a periodic basis, of which the assessment consists primarily of an evaluation of cash flow projections of the borrower to determine whether estimated cash flows are sufficient to repay principal and interest in accordance with the contractual terms of the note. We recognize impairments on notes receivable when it is probable that principal and interest will not be received in accordance with the contractual terms of the loan. The amount of the impairment to be recognized generally is based on the fair value of the partnership's real estate that represents the primary source of loan repayment. See Note 3 "Notes and Interest Receivable from Related Parties" for details on our notes receivable.

### **Fair Value of Financial Instruments**

We apply the guidance in ASC Topic 820, "Fair Value Measurements and Disclosures" and include three levels defined as follows:

Level 1 Unadjusted quoted prices for identical and unrestricted assets or liabilities in active markets.

Level 2 Quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 Unobservable inputs that are significant to the fair value measurement.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

### **Related Parties**

We apply ASC Topic 805, “Business Combinations,” to evaluate business relationships. Related parties are persons or entities who have one or more of the following characteristics, which include entities for which investments in their equity securities would be required, trust for the benefit of persons including principal owners of the entities and members of their immediate families, management personnel of the entity and members of their immediate families and other parties with which the entity may deal if one party controls or can significantly influence the decision making of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests, or affiliates of the entity.

## Results of Operations

The following discussion is based on our “Statement of Operations” for the nine months ended September 30, 2017 and 2016, as included in Part I, Item 1. “Financial Statements” of this report. It is not meant to be an all-inclusive discussion of the changes in our net income applicable to common shares. Instead, we have focused on significant fluctuations within our operations that we feel are relevant to obtain an overall understanding of the change in income applicable to common shareholders.

Our current operations consist of land held subject to a sales contract. Our operating expenses consist mainly of general and administration costs related to the Company.

We also have other income and expense items. We receive interest income from the funds deposited with our Advisor at a rate of prime plus 1%. We have receivables from related parties which also provide interest income.

### *Comparison of the three months ended September 30, 2017 to the same period ended 2016:*

We had net income of \$0.6 million or \$0.15 per diluted share for the three months ended September 30, 2017 compared to net income of \$0.8 million or \$0.18 per diluted share for the same period ended 2016.

## Revenues

Land held subject to a sales contract is our sole operating segment. There was no income generated from this segment for the three months ended September 30, 2017 and 2016.

## Expenses

General and administrative expenses were \$93,000 for the three months ended September 30, 2017. This represents a decrease of \$21,000 compared to the prior period general and administrative expenses of \$114,000.

Advisory fees were \$166,000 for the three months ended September 30, 2017 compared to \$162,000 for the same period of 2016 for an increase of \$4,000. Advisory fees are computed based on a gross asset fee of 0.0625% per month (0.75% per annum) of the average of the gross asset value.

Net income fee to related party decreased \$14,000 to \$53,000 for the three months ended September 30, 2017 compared to the prior period. The net income fee paid to our Advisor is calculated at 7.5% of net income.

### **Other income (expense)**

Interest income decreased to \$0.9 million for the three months ended September 30, 2017 compared to \$1.1 million for the same period of 2016. The decrease of \$0.2 million was due primarily to the payoff, during 2017, of notes receivable related to three income-producing properties sold in a prior year.

### ***Comparison of the nine months ended September 30, 2017 to the same period ended 2016:***

We had net income of \$2.4 million or \$0.57 earnings per diluted share for each of the nine months ended September 30, 2017 and 2016.

### **Revenues**

Land held for development or sale is our sole operating segment. There was no income generated from this segment for the nine months ended September 30, 2017 and 2016.

### **Expenses**

General and administrative expenses were \$342,000 for the nine months ended September 30, 2017 compared to \$333,000 for the prior period for an increase of \$9,000.

Advisory fees were \$493,000 for the nine months ended September 30, 2017 compared to \$475,000 for the same period of 2016 for an increase of \$18,000. Advisory fees are computed based on a gross asset fee of 0.0625% per month (0.75% per annum) of the average of the gross asset value.

Net income fee to related party decreased \$4,000 to \$189,000 for the nine months ended September 30, 2017 compared to the prior period. The net income fee paid to our Advisor is calculated at 7.5% of net income.

### **Other income (expense)**

Interest income was \$3.1 million for the nine months ended September 30, 2017 compared to \$3.4 million for the nine months ended September 30, 2016. The decrease of \$0.3 million was due primarily to the payoff, during 2017, of notes receivable related to three income-producing properties sold in a prior year.

## **Liquidity and Capital Resources**

### **General**

Our principal liquidity needs are:

meet debt service requirements including balloon payments;

fund normal recurring expenses;

fund capital expenditures; and

fund new property acquisitions.

Our primary source of cash is from collection on receivables and the sale of assets and the refinancing of existing mortgages. We will refinance debt obligations as they become due and generate cash from interest payments on notes receivable and the sale of properties. However, if refinancing and excess cash from operations does not prove to be



sufficient to satisfy all our obligations as they mature, we may sell real estate, refinance real estate, and incur additional borrowings secured by real estate to meet our cash requirements.

### Cash Flow Summary

The following summary discussion of our cash flows is based on the Consolidated Statements of Cash Flows from Part I, Item 1. “Financial Statements” and is not meant to be an all-inclusive discussion of the changes in our cash flows (dollars in thousands):

	September 30,		
	2017	2016	Variance
Net cash provided by operating activities	\$12,626	\$4,472	\$ 8,154
Net cash used in investing activities	(12,623)	(4,473)	(8,150 )
Net cash used in financing activities	—	—	—

The primary use of cash for operations is daily operating costs, general and administrative expenses, advisory fees, and land holding costs. Our primary source of cash for operations is from interest income on notes receivable.

Our primary cash outlays for investing activities are for investment of excess cash with our Advisor. The investing activity in the current period was mainly due to the proceeds received on the notes receivable. We invested more cash with our Advisor in the current period.

We did not pay quarterly dividends in 2017 or 2016.

## **Environmental Matters**

Under various federal, state and local environmental laws, ordinances and regulations, we may be potentially liable for removal or remediation costs, as well as certain other potential costs, relating to hazardous or toxic substances (including governmental fines and injuries to persons and property) where property-level managers have arranged for the removal, disposal or treatment of hazardous or toxic substances. In addition, certain environmental laws impose liability for release of asbestos-containing materials into the air and third parties may seek recovery for personal injury associated with such materials.

Management is not aware of any environmental liability relating to the above matters that would have a material adverse effect on our business, assets or results of operations.

## **Inflation**

The effects of inflation on our operations are not quantifiable. Fluctuations in the rate of inflation affect the sales value of properties and the ultimate gain to be realized from property sales. To the extent that inflation affects interest rates, earnings from short-term investments and the cost of new financings, as well as the cost of variable interest rate debt, will be affected.

## **Tax Matters**

IOR is a member of the May Realty Holdings, Inc. consolidated group for federal income tax reporting. There is a tax sharing and compensating agreement between American Realty Investors, Inc., Transcontinental Realty Investors, Inc. and IOR.

Financial statement income varies from taxable income principally due to the accounting for income and losses of investees, gains and losses from asset sales, depreciation on owned properties, amortization of discounts on notes receivable and payable and the difference in the allowance for estimated losses. IOR has taxable income for the nine months of 2017 on a standalone basis. This taxable income will be offset by the sharing of NOLs from the MRHI consolidated group.

At September 30, 2017, IOR had a net deferred tax asset of approximately \$1.3 million due to tax deductions available to the Company on a standalone basis in future years.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

At September 30, 2017, the Company had no outstanding debt and has no exposure to quantitative or qualitative issues.

### **ITEM 4. CONTROLS AND PROCEDURES**

Based on an evaluation by our management (with the participation of our Principal Executive Officer and Principal Financial Officer), as of the end of the period covered by this report, our Principal Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), were effective to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms and that such information is accumulated and communicated to our management, including our Principal Executive Officer and Principal Financial Officer, to allow timely decisions regarding required disclosures.

There has been no change in our internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)) during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **PART II. OTHER INFORMATION**

### **ITEM 5. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

On December 5, 1989, the governing body of the predecessor of the Company approved a share repurchase program authorizing the repurchase of up to a total of 200,000 shares of the predecessor. In June 2000, the Board of Directors of the Company increased the authorization to 500,000 shares. With the 3-for-1 forward split of the Company's Common Stock in June 2005, such authorization would be appropriately increased to 1,500,000 shares and the number of shares previously purchased would be appropriately increased by the same ratio. On August 10, 2010, the Board of Directors approved an increase in the share repurchase program for up to an additional 150,000 shares of common stock which results in a total authorization under the repurchase program for up to 1,650,000 shares of our common stock. This repurchase program has no termination date. There were no shares purchased under this program during the third quarter of 2017. As of September 30, 2017, 1,034,761 shares have been purchased and 615,239 shares may be purchased under the program.

**ITEM 6. EXHIBITS**

The following documents are filed herewith as exhibits or incorporated by reference as indicated:

Exhibit Number	Description
3.0	<u>Articles of Incorporation of Income Opportunity Realty Investors, Inc., (incorporated by reference to Appendix C to the Registrant's Registration Statement on Form S-4, dated February 12, 1996).</u>
3.1	<u>Bylaws of Income Opportunity Realty Investors, Inc. (incorporated by reference to Appendix D to the Registrant's Registration Statement on Forms S-4 dated February 12, 1996).</u>
10.3	<u>Advisory Agreement dated as of April 30, 2011 between Income Opportunity Realty Investors, Inc. and Pillar Income Asset Management, Inc. (incorporated by reference to Exhibit 10.3 to the registrant's current on Form 10-Q for event of May 2, 2011).</u>
10.4	<u>Loan Purchase Agreement (without exhibits), dated as of June 7, 2013 between IORI Operating Inc. and BDF TCI Mercer III, LLC.</u>
10.5	<u>Settlement and Release Agreement dated June 7, 2013 among TCI Mercer Crossing, Inc., Income Opportunity Realty Investors, Inc., Transcontinental Lamar, Inc., Transcontinental Realty Investors, Inc., Prime Income Asset Management, LLC, American Realty Investors, Inc., American Realty Trust, Inc., Transcontinental Realty Investors, Inc., BDF TCI Mercer III, LLC, and Transcontinental BDF III, LLC.</u>
31.1 *	<u>Certification by the Principal Executive Officer pursuant to Rule 13a-14 and 15d-14 under the Securities Exchange Act of 1934, as amended.</u>
31.2 *	<u>Certification by the Principal Financial Officer pursuant to Rule 13a-14 and 15d-14 under the Securities Exchange Act of 1934, as amended.</u>
32.1 *	<u>Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

\* Filed herewith

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

INCOME OPPORTUNITY REALTY INVESTORS, INC.

Date: November 14, 2017 By: /s/ Daniel J. Moos  
Daniel J. Moos  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: November 14, 2017 By: /s/ Gene S. Bertcher  
Gene S. Bertcher  
Executive Vice President and Chief Financial Officer  
(Principal Financial Officer)