CAPITAL PACIFIC HOLDINGS INC
Form 10-Q
July 15, 2003

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended May 31, 2003

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

Commission File Number: 001-09911

Capital Pacific Holdings, Inc.

(Exact name of Registrant as specified in its charter)

Delaware	**95-2956559**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification Number)*
4100 MacArthur Blvd., Newport Beach, CA	**92660**
(Address of principal executive offices)	*(Zip Code)*

Registrant s telephone number, including area code

(949) 622-8400

Indicate by check mark whether the Registrant (1) 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 þ No o

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

Class and Title of Capital Stock	Shares Outstanding as of June 30, 2003
Common Stock, $0.10 Par Value	12,907,050
Non-Voting Common Stock, $0.10 Par Value	2,007,312

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PART I FINANCIAL INFORMATION

Item 1. *Financial Statements*

CAPITAL PACIFIC HOLDINGS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)

	May 31, 2003	February 28, 2003
	(Unaudited)	
ASSETS		
Cash and cash equivalents	$ 6,403	$ 6,231
Restricted cash	495	495
Accounts and notes receivable	11,752	16,192
Real estate projects	212,047	184,891
Consolidated inventory not owned	17,694	
Property and equipment	7,711	7,679
Investment in and advances to unconsolidated joint ventures	14,636	14,303
Prepaid expenses and other assets	22,625	21,956
Total assets	$ 293,363	$ 251,747
LIABILITIES AND STOCKHOLDERS EQUITY		
Accounts payable and accrued liabilities	$ 18,384	$ 20,141
Notes payable	153,446	126,563
Consolidated liabilities from inventory not owned	2,797	
Total liabilities	174,627	146,704
Minority interest	18,148	4,644
Stockholders equity:		
Common stock, par value $0.10 per share, 60,000,000 shares authorized; 16,230,000 shares issued; 14,914,362 shares outstanding	1,635	1,635
Additional paid-in capital	217,249	217,249
Accumulated deficit	(110,281)	(111,098)
Treasury stock	(4,875)	(4,875)
Accumulated other comprehensive income (loss)	(3,140)	(2,512)
Total stockholders equity	100,588	100,399
Total liabilities and stockholders equity	$ 293,363	$ 251,747

See accompanying notes to financial statements.

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CAPITAL PACIFIC HOLDINGS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)
(In thousands, except share data)

	Three Months Ended May 31, 2003	Three Months Ended May 31, 2002
Sales of homes and land	$ 43,471	$ 44,846
Cost of sales	(34,229)	(34,243)
Interest expense	(2,859)	(3,318)
Selling, general and administrative expenses	(7,730)	(6,707)
Income from unconsolidated joint ventures	1,640	356
Interest and other income, net	1,068	217
Income before provision for income taxes and cumulative effect of change in accounting principle	1,361	1,151
Provision for income taxes	(544)	(399)
Income before cumulative effect of change in accounting principle	817	752
Cumulative effect of change in accounting principle negative goodwill, net of tax effect		5,447
Net income	$ 817	$ 6,199
Earnings per common share basic and diluted:		
Income before cumulative effect of change in accounting principle	$ 0.05	$ 0.05
Cumulative effect of change in accounting principle negative goodwill, net of tax effect		0.37
Net income	$ 0.05	$ 0.42
Weighted average common shares basic	14,914	14,853
Weighted average common shares diluted	14,939	14,958

See accompanying notes to financial statements.

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CAPITAL PACIFIC HOLDINGS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In thousands)

	For the Three Months Ended May 31,	
	2003	**2002**
Operating activities:		
Net income	$ 817	$ 6,199
Adjustments to reconcile net income to net cash used in operating activities:		
Gain on sale of assets	(854)	
Depreciation and amortization	304	122
Accretion of deferred gain	(71)	(177)
Cumulative effect of change in accounting principle		(5,447)
(Increase) decrease in real estate projects	(27,156)	2,221
Decrease (increase) in receivables, prepaid expenses and other assets	2,127	(3,100)
Decrease in accounts payable and accrued liabilities	(2,732)	(13,824)
Net cash used in operating activities	(27,565)	(14,006)
Investing activities:		
Proceeds from sale of assets	854	
Purchases of property and equipment, net	(336)	(6,465)
(Increase) decrease in investment in and advances to unconsolidated joint ventures, net	(333)	181
Net cash provided by (used in) investing activities	185	(6,284)
Financing activities:		
Borrowings (payments) on notes payable, net	26,883	25,917
Capital contributions from minority interest, net	669	
Issuance of common stock		620
Repurchase of common stock and warrants		(790)
Net cash provided by financing activities	27,552	25,747
Net increase in cash and cash equivalents	172	5,457
Cash and cash equivalents at beginning of period	6,231	5,080
Cash and cash equivalents at end of period	$ 6,403	$ 10,537

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CAPITAL PACIFIC HOLDINGS, INC., AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The unaudited financial statements presented herein have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and note disclosures required by accounting principles generally accepted in the United States. These statements should be read in conjunction with the consolidated financial statements and notes thereto, included in the Form 10-K for the fiscal year ended February 28, 2003, of Capital Pacific Holdings, Inc. (the Company or CPH, Inc.). In the opinion of management, the financial statements presented herein include all adjustments (which are solely of a normal recurring nature) necessary to present fairly the Company s financial position and results of operations. The results of operations for the three month period ended May 31, 2003, are not necessarily indicative of the results that may be expected for the year ending February 29, 2004. The consolidated financial statements include the accounts of the Company, wholly-owned subsidiaries and certain majority owned joint ventures, as well as the accounts of Capital Pacific Holdings, LLC (CPH LLC), which is wholly owned by the Company. All other investments are accounted for on the equity method. All significant intercompany balances and transactions have been eliminated in consolidation.

2. Reclassifications

Certain items in prior period financial statements have been reclassified in order to conform with the current year presentation.

3. Company Organization and Operations

The Company is a regional builder and developer with operations throughout selected metropolitan areas of California, Texas, Arizona and Colorado. The Company s principal business activities are to build and sell single-family homes. The Company s single-family homes are targeted to entry-level, move-up and luxury buyers.

In fiscal year 1998, the Company consummated an equity and restructuring transaction whereby CPH, Inc. and certain of its subsidiaries transferred to CPH LLC substantially all of their respective assets and CPH LLC assumed all the liabilities of CPH, Inc. and its subsidiaries. An unaffiliated investment company, California Housing Finance, L.P. (CHF) then acquired a minority interest in CPH LLC as a result of a cash investment in CPH LLC. From fiscal 1998 through fiscal 2001, CPH, Inc. and CHF entered into various joint ventures.

In February and May of 2001, CPH, Inc. and CHF consummated an interest exchange transaction (the Exchange Transaction), whereby CPH, Inc. exchanged its interests in the majority of the joint ventures capitalized by CHF, including certain entities which were previously consolidated (the Divested Joint Ventures), for CHF s interest in CPH LLC and certain residential joint ventures. The consideration for the Exchange Transaction included CHF s acquisition of 1,235,000 shares of non-voting Common Stock of CPH, Inc. at the equivalent of approximately $6.40 per share. As a result of the Exchange Transaction, CPH, Inc. owns 100% of CPH LLC, and obtained an increment of CPH LLC s total capital of $35.1 million. In addition, Capital Pacific Homes, Inc., a wholly-owned subsidiary of CPH, Inc., has entered into construction, management and marketing agreements relating to certain of the Divested Joint Ventures with residential components (the Managed Projects), whereby the Company is compensated for performing such services through a management fee arrangement, including reimbursement of all project costs. As a result of the Exchange Transaction, the Company has no further exposure to the economic or entitlement risks associated with the Divested Joint Ventures or the Managed Projects, including no obligation to provide any capital.

The Exchange Transaction was accounted for as the simultaneous acquisition of CHF s minority interest in CPH LLC and certain other residential joint ventures and the disposition of the Company s interest in the

CAPITAL PACIFIC HOLDINGS, INC., AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Divested Joint Ventures. As a result, no gain was initially recognized, the remaining balance of the Company s property and equipment was adjusted to zero at February 28, 2001, and again at May 31, 2001, a deferred gain of approximately $3.5 million was recorded on the disposition of one of the Divested Joint Ventures, and the balance of the transaction was recorded as negative goodwill in the amount of $6.8 million. Negative goodwill represents a portion of the positive difference between the Company s basis in the assets acquired in the Exchange Transaction as compared to the assets which were divested which was not otherwise accounted for as an adjustment to property and equipment or as a deferred gain. Both negative goodwill and the deferred gain were being accreted over five years, which accretion was included as a reduction in selling, general and administrative expenses. As further discussed in Note 13 below, due to a recently promulgated change in accounting principles, the remaining $5.4 million in unaccreted negative goodwill as of February 28, 2002 increased net income in the quarter ended May 31, 2002 through a cumulative effect of change in accounting principle. The remaining deferred gain was being accreted over the four years of its remaining expected life. However, in fiscal 2003, the Company terminated a portion of its lease from the Divested Joint Venture noted above and did not renew a consulting agreement covering all of the Divested Joint Ventures, thus eliminating its continuing involvement on a portion of the deferred gain resulting in an acceleration of the accretion of the deferred gain in the amount of $1.3 million in the fourth quarter of fiscal 2003. The remaining deferred gain of $777,000 at May 31, 2003 is being accreted over the three years of its remaining expected life.

Assets under management, including assets owned by unconsolidated joint ventures and Managed Projects, totaled $542 million at May 31, 2003 in 66 residential projects. At May 31, 2003, CPH LLC, which is wholly owned by the Company, had $282 million in assets and a net worth of $108 million. The Company and its subsidiaries perform their respective management functions for CPH LLC and the Managed Projects, pursuant to management agreements, which include provisions for the reimbursement of Company and subsidiary costs and a management fee. CPH LLC, the Managed Projects and certain other project-specific entities indemnify CPH, Inc. and its subsidiaries against liabilities arising from the projects owned by such entities. The Company maintains certain licenses and other assets as are necessary to fulfill its obligations as managing member and under management agreements.

References to the Company are, unless the context indicates otherwise, also references to CPH LLC and the project-specific entities in which the Company has an equity ownership interest. At the current time, all material financing transactions and arrangements are incurred either by CPH LLC or by the project-specific entities.

4. Consolidation of Variable Interest Entities

In January 2003, the Financial Accounting Standards Board (FASB) issued Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46). FIN 46 addresses the consolidation of Variable Interest Entities (VIEs). Under FIN 46, arrangements that are not controlled through voting or similar rights are accounted for as VIEs. An enterprise is required to consolidate a VIE if it is the primary beneficiary of the VIE. FIN 46 applies immediately to arrangements created after January 31, 2003 and, with respect to arrangements created before February 1, 2003, the interpretation will apply to the Company beginning on September 1, 2003. Arrangements entered into subsequent to January 31, 2003 have been evaluated under FIN 46 and, if applicable, accounted for in accordance with FIN 46.

Under FIN 46, a VIE is created when (i) the equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties or (ii) equity holders either (a) lack direct or indirect ability to make decisions about the entity, (b) are not obligated to absorb expected losses of the entity or (c) do not have the right to receive expected residual returns of the entity if they occur. If an entity is deemed to be a VIE, pursuant to FIN 46, an enterprise that absorbs a majority of the expected losses or residual returns of the VIE is considered the primary beneficiary and must consolidate the VIE.

CAPITAL PACIFIC HOLDINGS, INC., AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Based on the provisions of FIN 46, the Company has concluded that under certain circumstances when the Company options land or lots from an entity and pays a non-refundable deposit, a VIE is created under condition (ii) (b) of the previous paragraph. The Company has been deemed to have provided subordinated financial support, which refers to variable interests that will absorb some or all of an entity s expected theoretical losses if they occur. For each VIE created the Company will compute expected losses and residual returns based on the probability of future cash flows as outlined in FIN 46. If the Company is deemed to be the primary beneficiary of the VIE, it will be consolidated on the balance sheet. The fair value of the applicable VIE s inventory is reported as consolidated inventory not owned in the accompanying consolidated balance sheet at May 31, 2003.

At May 31, 2003 the Company consolidated two VIEs created between March 1, 2003 and May 31, 2003 as a result of options to purchase land or lots from the selling entities. The Company paid cash deposits to these two VIEs totaling $2.1 million. Other than normal due diligence and transaction expenses, the Company s option deposits represent the Company s maximum exposure to loss. At May 31, 2003, the fair value of the property owned by the VIEs was approximately $17.7 million. To the extent the amount of any debt held by the selling entities could be determined, it has been reflected as consolidated liabilities from inventory not owned in the accompanying consolidated balance sheet at May 31, 2003. The fair value of the optioned property less these liabilities and the cash deposits, which totaled $12.8 million, was reported on the accompanying consolidated balance sheet as minority interest. Creditors of these VIEs have no recourse against the Company.

The Company has not yet determined the anticipated impact of adopting FIN 46 for arrangements existing as of January 31, 2003. However, it may require the consolidation in the Company s third quarter financial statements as of November 30, 2003 of the assets, liabilities and operations of certain existing homebuilding and land development joint ventures, as well as option contracts with land sellers or third-party financial entities. Since the Company already recognizes its proportionate share of joint venture earnings and losses under the equity method of accounting, the adoption of FIN 46 will not affect the Company s consolidated net income.

5. Investments in and Advances to Unconsolidated Entities

The Company is a general partner or a direct or indirect managing member and has a 50 percent or lesser ownership in 13 unconsolidated entities at May 31, 2003. The Company s net investment in and advances to unconsolidated entities are as follows at May 31, 2003 and February 28, 2003 (in thousands):

	Capital Interest	May 31, 2003	February 28, 2003
Unconsolidated Joint Ventures:			
LB/L CPH Providence, LLC	10%	$ 151	$ 151
LB/L CPH Longmont, LLC	10%	2,734	2,529
LB/L CPH Laguna Street, LLC	10%		1,119
CPH Daily Ranch, L.P.	10%	3,584	3,251
CPH Sierra Peak, L.P.	50%	5,139	4,650
CPH Banning-Lewis Ranch, LLC		1,470	1,062
Other	Various	1,558	1,541
		$14,636	$14,303

The Company s economic interests in the unconsolidated joint ventures vary. Generally, the Company receives a portion of earnings after repayment of invested capital and payment of a preferred return on invested capital is provided. Typically, the majority of capital is provided by capital partners. In addition, the Company

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CAPITAL PACIFIC HOLDINGS, INC., AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

is typically required to contribute the full amount of its capital obligation at the commencement of the joint venture s business, but in some cases the Company may have a contingent obligation to contribute additional capital. The Company is typically the direct or indirect managing entity pursuant to terms in each venture s agreement. In the case of Divested Joint Ventures which are now Managed Projects, the Company or a subsidiary manages the development of the project under a management contract. Such management contracts as well as the unconsolidated joint venture agreements typically provide for the payment of a fee to compensate the Company for overhead expenditures as well as reimbursement of all direct project costs. The Company provides for income taxes currently on its share of distributed and undistributed earnings and losses from the investments.

The Company uses the equity method of accounting for its investments in the unconsolidated 50 percent or less owned entities. The accounting policies of the entities are substantially the same as those of the Company.

Following is summarized, combined financial information for the unconsolidated entities at May 31, 2003 and February 28, 2003 and for the three month periods ended May 31, 2003 and May 31, 2002 (in thousands). This information includes in each case the interest of all equity owners of the entities, not just that of the Company and its subsidiaries.

Assets

	May 31, 2003	February 28, 2003
Cash	$ 2,036	$ 299
Real estate projects	123,319	120,313
Other assets	1,211	2,997
	$126,566	$123,609

Liabilities and Equity

	May 31, 2003	February 28, 2003
Accounts payable and other liabilities	$ 12,098	$ 9,510
Notes payable	11,521	7,014
	23,619	16,524
Equity	102,947	107,085
	$126,566	$123,609

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CAPITAL PACIFIC HOLDINGS, INC., AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Income Statement

	Three Months Ended	
	May 31, 2003	**May 31, 2002**
Sales of homes and land	$11,188	$9,517
Interest and other income, net	146	248
	11,334	9,765
Costs and expenses	8,324	8,651
Net income	$ 3,010	$1,114

6. Warranty Costs

Estimated future warranty costs are accrued and charged to cost of sales for each home concurrent with the recognition of revenue upon satisfaction of the requirements of SFAS 66. Amounts accrued are based upon historical experience rates. Accrued warranty reserve is included in accounts payable and accrued liabilities in the accompanying consolidated balance sheets. Changes in the Company s warranty reserve are detailed in the table set forth below (in thousands):

	Three Months Ended May 31,	
	2003	**2002**
Accrued warranty reserve, beginning of the period	1,242	1,923
Warranty costs accrued during the period	204	321
Warranty costs paid during the period	(435)	(472)
Accrued warranty reserve, end of the period	1,011	1,772

7. Notes Payable

Notes payable at May 31, 2003 and February 28, 2003, are summarized as follows (in thousands):

	May 31, 2003	**February 28, 2003**
Senior unsecured revolving credit facility, bearing interest varying from LIBOR to prime, as selected by the Company, plus applicable margins	$110,126	$97,626
Senior subordinated note, bearing interest at LIBOR plus applicable margin, maturing October 31, 2007	20,000	20,000

Purchase money obligations related to real estate acquisitions	18,617	950
Non-recourse notes payable to banks		1,900