STRATUS PROPERTIES INC
Form 10-Q
August 09, 2018

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

FORM 10-Q

(Mark One)

[X]	QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the quarterly period ended June 30, 2018 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: 001-37716

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

Delaware	72-1211572
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

212 Lavaca St., Suite 300 Austin, Texas	78701

(Address of principal executive offices) (Zip Code)

(512) 478-5788
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
þ 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). þ Yes ¨ No
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and "emerging growth company" in Rule 12b-2 of the Exchange Act.

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). ¨ Yes þ No
On July 31, 2018, there were issued and outstanding 8,153,370 shares of the registrant’s common stock, par value $0.01 per share.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

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

	June 30, 2018	December 31, 2017
ASSETS		
Cash and cash equivalents	$12,660	$ 14,611
Restricted cash	24,637	24,779
Real estate held for sale	19,677	22,612
Real estate under development	140,210	118,484
Land available for development	15,428	14,804
Real estate held for investment, net	210,425	188,390
Deferred tax assets	12,114	11,461
Other assets	13,537	10,852
Total assets	$448,688	$ 405,993
LIABILITIES AND EQUITY		
Liabilities:		
Accounts payable	$22,195	$ 22,809
Accrued liabilities, including taxes	7,834	13,429
Debt	265,872	221,470
Deferred gain	10,480	11,320
Other liabilities	10,485	9,575
Total liabilities	316,866	278,603
Commitments and contingencies		
Equity:		
Stockholders' equity:		
Common stock	93	93
Capital in excess of par value of common stock	185,757	185,395
Accumulated deficit	(39,848)	(37,121)
Common stock held in treasury	(21,260)	(21,057)
Total stockholders' equity	124,742	127,310
Noncontrolling interests in subsidiaries	7,080	80
Total equity	131,822	127,390
Total liabilities and equity	$448,688	$ 405,993

The accompanying Notes to Consolidated Financial Statements (Unaudited) are an integral part of these consolidated financial statements.

STRATUS PROPERTIES INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS (Unaudited)
(In Thousands, Except Per Share Amounts)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2018	2017	2018	2017
Revenues:				
Real estate operations	$6,979	$4,021	$8,173	$6,185
Leasing operations	2,331	1,811	4,335	4,092
Hotel	9,593	9,765	18,915	20,079
Entertainment	4,407	5,832	9,652	11,737
Total revenues	23,310	21,429	41,075	42,093
Cost of sales:				
Real estate operations	5,560	3,868	7,126	5,844
Leasing operations	1,323	973	2,505	2,658
Hotel	7,149	7,436	14,178	14,601
Entertainment	3,436	4,255	7,404	8,632
Depreciation	2,053	1,756	3,995	3,897
Total cost of sales	19,521	18,288	35,208	35,632
General and administrative expenses	3,015	2,846	5,996	6,242
Profit participation in sale of The Oaks at Lakeway	—	—	—	2,538
Gain on sale of assets	—	—	—	(1,115)
Total	22,536	21,134	41,204	43,297
Operating income (loss)	774	295	(129)	(1,204)
Interest expense, net	(1,742)	(1,508)	(3,301)	(3,483)
Gain (loss) on interest rate derivative instruments	80	(4)	258	82
Loss on early extinguishment of debt	—	—	—	(532)
Other income, net	11	13	22	18
Loss before income taxes and equity in unconsolidated affiliates' loss	(877)	(1,204)	(3,150)	(5,119)
Equity in unconsolidated affiliates' loss	(3)	(2)	(6)	(19)
Benefit from income taxes	23	321	429	1,583
Net loss and total comprehensive loss	(857)	(885)	(2,727)	(3,555)
Total comprehensive income attributable to noncontrolling interests in subsidiaries	—	(8)	—	(8)
Net loss and total comprehensive loss attributable to common stockholders	$(857)	$(893)	$(2,727)	$(3,563)
Basic and diluted net loss per share attributable to common stockholders	$(0.11)	$(0.11)	$(0.33)	$(0.44)
Basic and diluted weighted average common shares outstanding	8,153	8,127	8,145	8,114
Dividends declared per share of common stock	$—	$—	$—	$1.00

The accompanying Notes to Consolidated Financial Statements (Unaudited) are an integral part of these consolidated financial statements.

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

	Six Months Ended June 30, 2018	2017
Cash flow from operating activities:		
Net loss	$(2,727)	$(3,555)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	3,995	3,897
Cost of real estate sold	5,053	3,897
Gain on sale of assets	—	(1,115)
Gain on interest rate derivative contracts	(258)	(82)
Loss on early extinguishment of debt	—	532
Debt issuance cost amortization and stock-based compensation	791	647
Equity in unconsolidated affiliates' loss	6	19
Increase (decrease) in deposits	588	(851)
Deferred income taxes	(653)	(12,607)
Purchases and development of real estate properties	(7,699)	(7,974)
Municipal utility district reimbursement	—	2,172
(Increase) decrease in other assets	(2,297)	910
Decrease in accounts payable, accrued liabilities and other	(5,505)	(895)
Net cash used in operating activities	(8,706)	(15,005)
Cash flow from investing activities:		
Capital expenditures	(42,982)	(5,100)
Proceeds from sale of assets	—	117,261
Payments on master lease obligations	(932)	(927)
Other, net	(87)	(48)
Net cash (used in) provided by investing activities	(44,001)	111,186
Cash flow from financing activities:		
Borrowings from credit facility	22,336	20,200
Payments on credit facility	(4,225)	(51,775)
Borrowings from project loans	29,948	7,766
Payments on project and term loans	(3,266)	(63,723)
Cash dividend paid	—	(8,127)
Stock-based awards net payments	(203)	(234)
Noncontrolling interests contributions	7,000	—
Financing costs	(976)	(375)
Net cash provided by (used in) financing activities	50,614	(96,268)
Net decrease in cash, cash equivalents and restricted cash	(2,093)	(87)
Cash, cash equivalents and restricted cash at beginning of year	39,390	25,489
Cash, cash equivalents and restricted cash at end of period	$37,297	$25,402

The accompanying Notes to Consolidated Financial Statements (Unaudited), which include information regarding noncash transactions, are an integral part of these consolidated financial statements.

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

	Stockholders' Equity								
	Common Stock				Common Stock Held in Treasury				
	Number of Shares	At Par Value	Capital in Excess of Par Value	Accum-ulated Deficit	Number of Shares	At Cost	Total Stockholders' Equity	Noncontrolling Interests in Subsidiaries	Total Equity
Balance at December 31, 2017	9,250	$ 93	$ 185,395	$ (37,121)	1,117	$ (21,057)	$ 127,310	$ 80	$ 127,390
Vested stock-based awards	27	—	—	—	—	—	—	—	—
Stock-based compensation	—	—	362	—	—	—	362	—	362
Tender of shares for stock-based awards	—	—	—	—	7	(203)	(203)	—	(203)
Noncontrolling interests contributions	—	—	—	—	—	—	—	7,000	7,000
Total comprehensive loss	—	—	—	(2,727)	—	—	(2,727)	—	(2,727)
Balance at June 30, 2018	9,277	$ 93	$ 185,757	$ (39,848)	1,124	$ (21,260)	$ 124,742	$ 7,080	$ 131,822
Balance at December 31, 2016	9,203	$ 92	$ 192,762	$ (41,143)	1,105	$ (20,760)	$ 130,951	$ 75	$ 131,026
Adjustment for cumulative effect of change in accounting for stock-based compensation	—	—	—	143	—	—	143	—	143
Cash dividend	—	—	(8,127)	—	—	—	(8,127)	—	(8,127)
Exercised and vested stock-based awards	40	1	62	—	—	—	63	—	63
Stock-based compensation	—	—	383	—	—	—	383	—	383
Tender of shares for stock-based awards	—	—	—	—	12	(297)	(297)	—	(297)
Total comprehensive (loss) income	—	—	—	(3,563)	—	—	(3,563)	8	(3,555)
Balance at June 30, 2017	9,243	$ 93	$ 185,080	$ (44,563)	1,117	$ (21,057)	$ 119,553	$ 83	$ 119,636

The accompanying Notes to Consolidated Financial Statements (Unaudited) are an integral part of these consolidated financial statements.

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

1. GENERAL
The accompanying unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto for the year ended December 31, 2017, included in Stratus Properties Inc.'s (Stratus) Annual Report on Form 10-K (Stratus 2017 Form 10-K) filed with the United States (U.S.) Securities and Exchange Commission. The information furnished herein reflects all adjustments that are, in the opinion of management, necessary for a fair statement of the results for the interim periods reported. With the exception of the accounting for the deferred gain on the 2017 sale of The Oaks at Lakeway, all such adjustments are, in the opinion of management, of a normal recurring nature. Operating results for the six-month period ended June 30, 2018, are not necessarily indicative of the results that may be expected for the year ending December 31, 2018.

2. EARNINGS PER SHARE
Stratus' net loss per share of common stock was calculated by dividing the net loss attributable to common stockholders by the weighted-average shares of common stock outstanding during the period. The weighted-average shares exclude approximately 85 thousand shares of common stock for second-quarter 2018, 102 thousand shares for second-quarter 2017, 96 thousand shares for the first six months of 2018 and 115 thousand shares for the first six months of 2017 associated with restricted stock units and outstanding stock options that were anti-dilutive because of the net losses.

3. RELATED PARTY TRANSACTIONS
The Saint Mary, L.P.
On June 19, 2018, The Saint Mary, L.P., a Texas limited partnership and a subsidiary of Stratus, completed a series of financing transactions to develop The Saint Mary, a 240-unit luxury, garden-style apartment project in the Circle C community in Austin, Texas. The financing transactions included (1) a $26 million construction loan with Texas Capital Bank, National Association (see Note 6 for further discussion) and (2) an $8.0 million private placement. The Saint Mary, L.P. issued, in a private placement exempt from registration under federal and state securities laws, Class B limited partnership interests to a limited number of investors (the Saint Mary Class B limited partners), for $8.0 million (the Saint Mary Offering) resulting in the Saint Mary Class B limited partners owning an aggregate of 49.1 percent equity interest in The Saint Mary, L.P.

In accordance with the terms of the Saint Mary Offering, Circle C Land, L.P., a Texas limited partnership and a subsidiary of Stratus and the sole Class A limited partner of The Saint Mary, L.P. (Circle C) purchased Class B limited partnership interests representing a 6.1 percent equity interest in The Saint Mary, L.P. for $1.0 million. Upon completion of the Saint Mary Offering, Stratus holds, in aggregate, a 57 percent indirect equity interest in The Saint Mary, L.P. Additionally, among the participants in the Saint Mary Offering, LCHM Holdings, LLC, a related party as a result of its greater than 5 percent beneficial ownership of Stratus' common stock (LCHM), purchased Saint Mary Class B limited partnership interests representing a 6.1 percent equity interest in The Saint Mary, L.P. for $1.0 million.

In connection with the Saint Mary Offering, The Saint Mary GP, L.L.C., a Texas limited liability company (the Saint Mary General Partner) and a subsidiary of Stratus, Circle C, and the Saint Mary Class B limited partners entered into an Amended and Restated Limited Partnership Agreement (the Saint Mary Partnership Agreement) effective as of June 18, 2018. The Saint Mary Partnership Agreement includes the following key provisions:

- The Saint Mary, L.P. will be managed by the Saint Mary General Partner, and The Saint Mary, L.P. will pay the Saint Mary General Partner, or another affiliate of Stratus, an asset management fee of $210,000 per year beginning one year after construction of The Saint Mary begins.

- The Saint Mary, L.P. will pay the Saint Mary General Partner, or another affiliate of Stratus, a development management fee of approximately $1.4 million for the overall coordination and management of the development and construction of The Saint Mary.
- Circle C contributed an approximate 14.35 acre tract of land upon which The Saint Mary will be developed and constructed and $0.7 million of cash.
- The partners are entitled to preferred returns, which change after certain returns are achieved as specified in the Saint Mary Partnership Agreement.

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Stratus has performed evaluations and concluded that The Saint Mary, L.P. is a variable interest entity and that Stratus is the primary beneficiary. Stratus will continue to evaluate which entity is the primary beneficiary of The Saint Mary, L.P. in accordance with applicable accounting guidance. As of June 30, 2018, Stratus' consolidated balance sheet includes the following assets and liabilities of The Saint Mary, L.P. (in thousands):

	June 30, 2018
Assets:	
Restricted cash	$8,670
Real estate held under development	3,130
Other assets	400
Total assets	$12,200
Liabilities:	
Accounts payable	$521
Total liabilities	521
Net assets	$11,679

Stratus Kingwood Place, L.P.

On August 3, 2018, Stratus Kingwood Place, L.P., a Texas limited partnership and a subsidiary of Stratus (the Kingwood, L.P.), completed a $10.7 million private placement, approximately $7 million of which, combined with a $6.75 million loan from Comerica Bank, was used to purchase a 54-acre tract of land located in Kingwood, Texas, for the development, subject to obtaining a construction loan and building permits, of Kingwood Place, a new H-E-B, L.P. (HEB)-anchored mixed-use development project (Kingwood Place). The development plan for Kingwood Place includes a 103,000-square-foot HEB store, 41,000 square feet of retail space, 6 retail pads, and an 11-acre parcel planned for approximately 300 multi-family units. The Kingwood, L.P. issued, in a private placement exempt from registration under federal and state securities laws, Class B limited partnership interests to a limited number of investors (the Kingwood Class B limited partners), for $10.7 million (the Kingwood Offering), representing approximately 70 percent of the projected partnership equity. Among the participants in the Kingwood Offering, LCHM purchased Kingwood Class B limited partnership interests initially representing a 8.8 percent equity interest in the Kingwood, L.P. for $1.0 million.

In connection with the Kingwood Offering, Stratus Northpark, L.L.C., a Texas limited liability company, a subsidiary of Stratus and the general partner of the Kingwood, L.P. (the Kingwood General Partner), Stratus Properties Operating Co., L.P., a Delaware limited partnership, also a subsidiary of Stratus (the Class A limited partner), and the Kingwood Class B limited partners entered into an Amended and Restated Limited Partnership Agreement (the Kingwood Partnership Agreement) effective as of August 3, 2018. The Kingwood Partnership Agreement includes the following key provisions:

- The Kingwood, L.P. will be managed by the Kingwood General Partner, and the Kingwood, L.P. will pay the Kingwood General Partner, or another affiliate of Stratus, an asset management fee of $283,000 per year beginning one year after construction of Kingwood Place begins.
- The Kingwood, L.P. will pay the Kingwood General Partner, or another affiliate of Stratus, a development management fee equal to four percent of the construction costs for Kingwood Place for the overall coordination and management of the development and construction of Kingwood Place.
- The partners are entitled to preferred returns, which change after certain returns are achieved as specified in the Kingwood Partnership Agreement.

4. DISPOSITIONS

The Oaks at Lakeway. On February 15, 2017, Stratus sold The Oaks at Lakeway to FHF I Oaks at Lakeway, LLC for $114.0 million in cash. Net cash proceeds were $50.8 million after repayment of the Lakeway construction loan. Stratus used a portion of these net cash proceeds to pay indebtedness outstanding under the Comerica Bank credit facility. The parties entered into three master lease agreements at closing: (1) one covering unleased in-line retail space, with a 5-year term, (2) one covering four unleased pad sites, three of which have 10-year terms, and one of which has a 15-year term, and (3) one covering the hotel pad with a 99-year term. As specified conditions are met, primarily consisting of the tenant executing a lease, commencing payment of rent and taking occupancy, leases will be assigned to the purchaser and the corresponding property will be removed from the master lease, reducing Stratus' master lease payment obligations. Stratus' master lease payment obligation, which currently approximates $180 thousand per month, is expected to decline over time until leasing is complete and all leases are assigned to the purchaser.

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Stratus agreed to guarantee the obligations of its selling subsidiary under the sales agreement, up to a liability cap of two percent of the purchase price. This cap does not apply to Stratus' obligation to satisfy the selling subsidiary's indemnity obligations for its broker commissions or similar compensation or Stratus' liability in guaranteeing the selling subsidiary's obligations under the master leases. To secure its obligations under the master leases, Stratus has provided a $1.5 million irrevocable letter of credit with a three-year term.

At the date of sale, Stratus allocated the purchase price for The Oaks at Lakeway between two performance obligations based on the relative fair values of each. The first performance obligation, to deliver the completed and leased portion of the property, was performed on the date of sale. The second performance obligation was to complete construction of the remaining buildings and leasing of the vacant space. The obligations under master leases were considered variable consideration and are recorded as reductions to the contract liability. The hotel pad was leased to a hotel operator under a ground lease at the date of sale. However, the hotel tenant had not commenced rent payments or construction of the hotel. At the date of the sale, primarily because of the uncertainty related to the hotel tenant’s performance under its ground lease, the probability-weighted estimate of the obligations under the master leases reduced the sale consideration such that no gain was recognized on the sale.

Once the hotel tenant began paying rent in May 2017 and obtained construction financing and commenced construction of the hotel in August 2017, the probability-weighted estimate of Stratus’ obligations under the master leases was significantly reduced, and a gain of $24.3 million related to the first performance obligation was recognized in third-quarter 2017. A contract liability of $10.5 million is presented as a deferred gain in the consolidated balance sheets at June 30, 2018, compared with $11.3 million at December 31, 2017. The reduction in the deferred gain balance primarily reflects master lease payments. The contract liability, as reduced by future master lease payments, will be recognized as additional gain as Stratus fulfills the remaining performance obligation.

Upon the sale of The Oaks at Lakeway, HEB earned a profit participation of $2.5 million (of which $2.2 million was paid at closing), which is presented separately in the consolidated statements of comprehensive loss.

Barton Creek Village. On February 28, 2017, Stratus completed the sale of its 3,085-square-foot bank building and an adjacent undeveloped 4.1 acre tract of land in Barton Creek, for $3.1 million and recorded a gain on the sale of $1.1 million. In connection with the sale, a $2.1 million paydown was made on the Barton Creek Village term loan.

5. FAIR VALUE MEASUREMENTS

Fair value accounting guidance includes a hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs).

The carrying value for certain Stratus financial instruments (i.e., cash and cash equivalents, restricted cash, accounts payable and accrued liabilities) approximates fair value because of their short-term nature and generally negligible credit losses.

A summary of the carrying amount and fair value of Stratus' other financial instruments follows (in thousands):

	June 30, 2018		December 31, 2017	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets:				
Interest rate swap agreement	$123	$123	$—	$—
Liabilities:				
Debt	$265,872	$269,404	$221,470	$224,632

Interest rate swap agreement	—	—	134	134

Debt. Stratus' debt is recorded at cost and is not actively traded. Fair value is estimated based on discounted future expected cash flows at estimated current market interest rates. Accordingly, Stratus' debt is classified within Level 2 of the fair value hierarchy. The fair value of debt does not represent the amounts that will ultimately be paid upon the maturities of the loans.

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Interest Rate Swap Agreement. The interest rate swap does not qualify for hedge accounting and changes in its fair value are recorded in the consolidated statements of comprehensive loss. Stratus evaluated the counterparty credit risk associated with the interest rate swap agreement, which is considered a Level 3 input, but did not consider such risk to be significant. Therefore, the interest rate swap agreement is classified within Level 2 of the fair value hierarchy.

6. DEBT AND EQUITY

Debt. The components of Stratus' debt are as follows (in thousands):

	June 30, 2018	December 31, 2017
Goldman Sachs loan	$144,226	$ 145,195
Comerica Bank credit facility	43,877	25,765
Santal Phase I construction loan	32,572	31,864
Barton Creek Village term loan	3,330	3,375
Amarra Villas credit facility	4,490	5,247
West Killeen Market construction loan	5,936	5,378
Jones Crossing construction loan	10,170	4,646
Lantana Place construction loan	14,080	—
Santal Phase II construction loan	7,191	—
Total debt[a]	$265,872	$ 221,470

a. Includes net reductions for unamortized debt issuance costs of $2.5 million at June 30, 2018, and $2.1 million at December 31, 2017.

On June 29, 2018, Stratus entered into a loan agreement with Comerica Bank to modify, increase and extend Stratus' Comerica Bank credit facility, which was scheduled to mature on November 30, 2018. The new loan agreement provides for (1) an increase in the revolving credit facility from $45.0 million to $60.0 million, (2) a $7.5 million sublimit for letters of credit issuance and (3) an extension of the maturity date from November 30, 2018, to June 29, 2020. Advances under the credit facility bear interest at the annual London Interbank Offered Rate (LIBOR) plus 4.0 percent. The Comerica Bank credit facility is secured by substantially all of Stratus' assets, except for properties that are encumbered by separate debt financing. The loan agreement contains financial covenants usual and customary for loan agreements of this nature, including a requirement that Stratus maintains a net asset value of $125 million and an aggregate promissory note debt-to-gross asset value of less than 50 percent. As of June 30, 2018, Stratus had $12.0 million available under its $60.0 million Comerica Bank revolving credit facility, with $4.1 million of letters of credit committed against the available balance.

As discussed in Note 3, on June 19, 2018, Stratus entered into a $26 million construction loan with Texas Capital Bank (The Saint Mary construction loan) to finance the initial phase of The Saint Mary. Stratus will fully guaranty The Saint Mary construction loan. The repayment guaranty will be reduced to 50 percent upon issuance of a certificate of occupancy for The Saint Mary and will be eliminated when the project debt service coverage ratio equals or exceeds 1.25:1.0. Interest is variable at the one-month LIBOR plus 3.0 percent. Payments of interest only will be due and payable monthly, and outstanding principal is payable at maturity of June 19, 2021. Outstanding amounts will be secured by The Saint Mary and all subsequent improvements. The construction loan agreement and related document contain affirmative and negative covenants usual and customary for loan agreements of this nature. Stratus may extend the maturity of this loan for up to two additional 12-month periods if certain conditions are met, including debt service coverage ratio thresholds. As of June 30, 2018, no amounts were drawn on The Saint Mary construction loan.

For a description of Stratus' other debt, refer to Note 6 in the Stratus 2017 Form 10-K.

Interest Expense and Capitalization. Interest costs (before capitalized interest) totaled $3.8 million in second-quarter 2018, $2.9 million in second-quarter 2017, $7.2 million for the first six months of 2018 and $6.3 million for the first six months of 2017. Stratus' capitalized interest costs totaled $2.0 million in second-quarter 2018, $1.4 million in second-quarter 2017, $3.9 million for the first six months of 2018 and $2.8 million for the first six months of 2017, primarily related to development activities at Barton Creek.

Equity. Stratus' Comerica Bank credit facility requires the bank's prior written consent to pay a dividend on Stratus' common stock. On March 15, 2017, Stratus' Board of Directors (the Board), after receiving written consent from Comerica Bank, declared a special cash dividend of $1.00 per share ($8.1 million), which was paid on April 18, 2017, to stockholders of record on March 31, 2017. The special cash dividend was declared after the Board’s

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consideration of the results of the sale of The Oaks at Lakeway. Comerica Bank’s consent to the payment of this special dividend is not indicative of the bank’s willingness to consent to the payment of future dividends. The declaration of future dividends is at the discretion of the Board, subject to the restrictions under Stratus' Comerica Bank credit facility, and will depend on Stratus' financial results, cash requirements, projected compliance with covenants in its debt agreements, outlook and other factors deemed relevant by the Board.

7. INCOME TAXES

Stratus’ accounting policy for and other information regarding its income taxes is further described in Notes 1 and 7 in the Stratus 2017 Form 10-K.

Stratus had deferred tax assets (net of deferred tax liabilities) totaling $12.1 million at June 30, 2018, and $11.5 million at December 31, 2017. Stratus’ income tax benefit for the first six months of 2018 includes a deferred tax benefit of $0.7 million, partly offset by income tax expense of $0.2 million. Stratus’ future results of operations may be negatively impacted by an inability to realize a tax benefit for future tax losses or for items that will generate additional deferred tax assets.

The difference between Stratus' consolidated effective income tax rate for the first six months of 2018 and the first six months of 2017, and the U.S. Federal statutory income tax rate of 21 percent for 2018 and 35 percent for 2017, was primarily attributable to the Texas state margin tax.

8. BUSINESS SEGMENTS

Stratus currently has four operating segments: Real Estate Operations, Leasing Operations, Hotel and Entertainment.

The Real Estate Operations segment is comprised of Stratus’ real estate assets (developed, under development and available for development), which consists of its properties in Austin, Texas (the Barton Creek community, including Santal Phase II; the Circle C community, including The Saint Mary; the Lantana community, including Lantana Place; and the condominium units at the W Austin Hotel & Residences); in Lakeway, Texas, located in the greater Austin area (Lakeway); in College Station, Texas (Jones Crossing); and in Magnolia, Texas, located in the greater Houston area (Magnolia).

The Leasing Operations segment includes the office and retail space at the W Austin Hotel & Residences, a retail building in Barton Creek Village, Santal Phase I, the West Killeen Market in Killeen, Texas, and portions of the Lantana Place and Jones Crossing projects.

The Hotel segment includes the W Austin Hotel located at the W Austin Hotel & Residences in downtown Austin, Texas.

The Entertainment segment includes ACL Live, a live music and entertainment venue and production studio at the W Austin Hotel & Residences. In addition to hosting concerts and private events, this venue is the home of Austin City Limits, a television program showcasing popular music legends. The Entertainment segment also includes revenues and costs associated with events hosted at other venues, including 3TEN ACL Live, which opened in March 2016 on the site of the W Austin Hotel & Residences.

Stratus uses operating income or loss to measure the performance of each segment. General and administrative expenses, which primarily consist of employee salaries, wages and other costs, are managed on a consolidated basis and are not allocated to Stratus' operating segments. The following segment information reflects management determinations that may not be indicative of what the actual financial performance of each segment would be if it were an independent entity.

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Revenues From Contracts with Customers. Stratus' revenues from contracts with customers for the second quarters and the first six months of 2018 and 2017 follow (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Real Estate Operations:				
Developed property sales	$6,856	$3,443	$8,011	$5,576
Undeveloped property sales	—	544	—	544
Commissions and other	123	34	162	65
	6,979	4,021	8,173	6,185
Leasing Operations:				
Rental revenue	2,331	1,811	4,335	4,092
	2,331	1,811	4,335	4,092
Hotel:				
Rooms, food and beverage	8,908	9,122	17,602	18,911
Other	685	643	1,313	1,168
	9,593	9,765	18,915	20,079
Entertainment:				
Event revenue	3,729	5,215	8,378	10,510
Other	678	617	1,274	1,227
	4,407	5,832	9,652	11,737
Total Revenues from Contracts with Unaffiliated Customers	$23,310	$21,429	$41,075	$42,093

Financial Information by Business Segment. The following segment information was prepared on the same basis as Stratus' consolidated financial statements (in thousands).

	Real Estate Operations[a]	Leasing Operations	Hotel	Entertainment	Eliminations and Other[b]	Total
Three Months Ended June 30, 2018:						
Revenues:						
Unaffiliated customers	$ 6,979	$ 2,331	$9,593	$ 4,407	$ —	$23,310
Intersegment	8	225	50	44	(327)	—
Cost of sales, excluding depreciation	5,560 [c]	1,331	7,184	3,560	(167)	17,468
Depreciation	64	738	894	392	(35)	2,053
General and administrative expenses	—	—	—	—	3,015	3,015
Operating income (loss)	$ 1,363	$ 487	$1,565	$ 499	$ (3,140)	$774
Capital expenditures and purchases and development of real estate properties	$ 4,087	$ 18,486	$97	$ 23	$ —	$22,693
Total assets at June 30, 2018	207,437	95,954	101,487	36,263	7,547	448,688
Three Months Ended June 30, 2017:						
Revenues:						
Unaffiliated customers	$4,021	$1,811	$9,765	$5,832	$—	$21,429
Intersegment	8	221	82	85	(396)	—
Cost of sales, excluding depreciation	3,868	980	7,456	4,449	(221)	16,532
Depreciation	57	568	789	377	(35)	1,756
General and administrative expenses	—	—	—	—	2,846	2,846
Operating income (loss)	$104	$484	$1,602	$1,091	$(2,986)	$295

Capital expenditures and purchases and development of real estate properties	$ 4,306	$ 2,748	$ 11	$ 40	$ —	$ 7,105
Total assets at June 30, 2017	160,713	69,629	103,154	37,392	24,566	395,454

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	Real Estate Operations[a]	Leasing Operations	Hotel	Entertainment	Eliminations and Other[b]	Total
Six Months Ended June 30, 2018:						
Revenues:						
Unaffiliated customers	$ 8,173	$ 4,335	$18,915	$ 9,652	$ —	$41,075
Intersegment	16	476	122	58	(672)	—
Cost of sales, excluding depreciation	7,126 [c]	2,521	14,222	7,696	(352)	31,213
Depreciation	125	1,371	1,789	780	(70)	3,995
General and administrative expenses	—	—	—	—	5,996	5,996
Operating income (loss)	$ 938	$ 919	$3,026	$ 1,234	$ (6,246)	$(129)
Capital expenditures and purchases and development of real estate properties	$ 7,699	$ 42,285	$336	$ 361	$ —	$50,681
Six Months Ended June 30, 2017:						
Revenues:						
Unaffiliated customers	$6,185	$4,092	$20,079	$11,737	$—	$42,093
Intersegment	21	431	173	125	(750)	—
Cost of sales, excluding depreciation	5,844	2,673	14,645	8,957	(384)	31,735
Depreciation	114	1,331	1,768	753	(69)	3,897
General and administrative expenses	—	—	—	—	6,242	6,242
Profit participation	—	2,538	—	—	—	2,538
Gain on sales of assets	—	(1,115)	—	—	—	(1,115)
Operating income (loss)	$248	$(904)	$3,839	$2,152	$(6,539)	$(1,204)
Capital expenditures and purchases and development of real estate properties	$7,974	$4,779	$258	$63	$—	$13,074

a. Includes sales commissions and other revenues together with related expenses.

b. Includes consolidated general and administrative expenses and eliminations of intersegment amounts.

c. Includes $0.4 million of reductions to cost of sales associated with collection of prior-years' assessments of properties in Barton Creek.

9. NEW ACCOUNTING STANDARDS

Revenue Recognition. In May 2014, the Financial Accounting Standards Board (FASB) issued a new Accounting Standards Update (ASU) related to revenue recognition. Stratus adopted this standard effective January 1, 2018, under the modified retrospective approach applied to contracts that remain in force at the adoption date. The adoption of this standard did not result in any changes to Stratus' revenue recognition policies or processes (refer to Note 1 of Stratus' 2017 Form 10-K for disclosure of Stratus' revenue recognition policy) except as follows:

Revenue or gains on sales of real estate are recognized when control of the asset has been transferred to the buyer if collection of substantially all of the consideration to which Stratus will be entitled is probable and Stratus has satisfied all other performance obligations under the contract. Consideration is allocated among multiple performance obligations or distinct nonfinancial assets to be transferred to the buyer based on relative fair value.

Financial Instruments. In January 2016, FASB issued an ASU that amends the guidance on the classification and measurement of financial instruments. This ASU makes limited changes to prior guidance and amends certain disclosure requirements. Stratus adopted this ASU effective January 1, 2018, and the adoption did not have a material impact on its financial statements.

Leases. In February 2016, FASB issued an ASU that will require lessees to recognize most leases on the balance sheet. This ASU allows lessees to make an accounting policy election to not recognize a lease asset and liability for leases with a term of 12 months or less and do not have a purchase option that is expected to be exercised. For public entities, this ASU is effective for interim and annual reporting periods beginning after December 15, 2018, with early adoption permitted. In July 2018, FASB issued a practical expedient allowing for entities to apply the provisions of the updated lease guidance at the January 1, 2019, effective date, without adjusting the comparative periods presented. Stratus continues to review the impact of the new guidance on its financial reporting and disclosures, including the impact of the College Station ground lease.

Statement of Cash Flows: Restricted Cash. In November 2016, FASB issued an ASU that changes the classification and presentation of restricted cash and restricted cash equivalents on the statement of cash flows. The ASU

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requires that a statement of cash flows include the change during the period in the total of cash, cash equivalents and amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. Stratus adopted this ASU effective January 1, 2018, and adjusted its consolidated statement of cash flows for the six months ended June 30, 2017, to include restricted cash (Stratus has no restricted cash equivalents) with cash and cash equivalents.

The impact of adopting this ASU for the six months ended June 30, 2017, follows (in millions):

	Previously Reported	Impact of Adoption	Current Presentation
Net increase (decrease) in cash, cash equivalents and restricted cash	$ 1,208	$ (1,295)	$ (87)
Cash, cash equivalents and restricted cash at beginning of year	13,597	11,892	25,489
Cash, cash equivalents and restricted cash at end of period	$ 14,805	$ 10,597	$ 25,402

10. SUBSEQUENT EVENTS

On July 11, 2018, Stratus' Compensation Committee (the Committee) of the Board unanimously adopted the Stratus Profit Participation Incentive Plan to enable Stratus to attract and retain highly qualified employees who will contribute to Stratus’ long-term success by providing award opportunities that align the interests of Stratus’ executives, other employees and consultants designated by the Committee with those of Stratus’ stockholders.

On August 6, 2018, Stratus purchased a 54-acre tract of land in Kingwood, Texas to be developed as Kingwood Place. See Note 3 for further discussion.

Stratus evaluated events after June 30, 2018, and through the date the financial statements were issued, and determined any events or transactions occurring during this period that would require recognition or disclosure are appropriately addressed in these financial statements.

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

OVERVIEW

In Management’s Discussion and Analysis of Financial Condition and Results of Operations (MD&A), “we,” “us,” “our” and "Stratus" refer to Stratus Properties Inc. and all entities owned or controlled by Stratus Properties Inc. You should read the following discussion in conjunction with our consolidated financial statements, related MD&A and discussion of our business and properties included in our Annual Report on Form 10-K for the year ended December 31, 2017 (2017 Form 10-K) filed with the United States (U.S.) Securities and Exchange Commission (SEC). The results of operations reported and summarized below are not necessarily indicative of future operating results, and future results could differ materially from those anticipated in forward-looking statements (refer to “Cautionary Statement” for further discussion). All subsequent references to “Notes” refer to Notes to Consolidated Financial Statements (Unaudited) located in Part I, Item 1. “Financial Statements” of this Form 10-Q, unless otherwise stated.

We are a diversified real estate company engaged primarily in the acquisition, entitlement, development, management, operation and sale of commercial, hotel, entertainment, and multi-family and single-family residential real estate properties, primarily located in the Austin, Texas area, and also including projects in certain other select markets in Texas. We generate revenues and cash flows from the sale of developed properties, rental income from our leased properties and from our hotel and entertainment operations. See Note 8 for further discussion of our operating segments.

Developed property sales can include an individual tract of land that has been developed and permitted for residential use, a developed lot with a home already built on it or condominium units at the W Austin Residences. We may sell properties under development, undeveloped properties or leased properties, if opportunities arise that we believe will maximize overall asset values as part of our business plan. See "Business Strategy" below.

Our acreage under development and undeveloped as of June 30, 2018, is presented in the following table.

	Under Development				Undeveloped				
	Single Family	Multi-family	Commercial	Total	Single family	Multi-family	Commercial	Total	Total Acreage
Austin:									
Barton Creek	4	41	—	45	512	266	394	1,172	1,217
Circle C	—	15	—	15	—	21	216	237	252
Lantana	—	—	6	6	—	—	39	39	45
Other	—	—	—	—	7	—	—	7	7
Lakeway	—	—	—	—	35	—	—	35	35
Magnolia	—	—	—	—	—	—	124	124	124
Jones Crossing	—	—	16	16	—	—	48	48	64
Camino Real, San Antonio	—	—	—	—	—	—	2	2	2
Total	4	56	22	82	554	287	823	1,664	1,746

In second-quarter 2018, our revenues totaled $23.3 million and our net loss attributable to common stockholders totaled $0.9 million, compared with revenues of $21.4 million and a net loss attributable to common stockholders of $0.9 million for second-quarter 2017. During the first six months of 2018, our revenues totaled $41.1 million and our net loss attributable to common stockholders totaled $2.7 million, compared with revenues of $42.1 million and a net loss attributable to common stockholders of $3.6 million for the first six months of 2017.

The increase in revenues in second-quarter 2018, compared with second-quarter 2017, primarily reflects higher developed property sales. The decrease in revenues for the first six months of 2018, compared with the first six months of 2017, primarily reflects lower revenues from the Entertainment and Hotel segments, partly offset by higher revenues from developed property sales.

The net loss attributable to common stockholders for the first six months of 2017 includes a $2.5 million charge ($1.6 million to net loss attributable to common stockholders) for profit participation costs and a $0.5 million loss ($0.3

million to net loss attributable to common stockholders) on early extinguishment of debt, both related to our

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sale of The Oaks at Lakeway, partly offset by a $1.1 million gain ($0.7 million to net loss attributable to common stockholders) on the sale of a bank building and an adjacent undeveloped 4.1 acre tract of land at Barton Creek.
At June 30, 2018, we had total debt of $265.9 million and total cash and cash equivalents of $12.7 million, compared with total debt of $221.5 million and cash and cash equivalents of $14.6 million at December 31, 2017. We have significant recurring costs, including property taxes, maintenance and marketing, and we believe we will have sufficient sources of debt financing and cash from operations to meet our cash requirements. See “Capital Resources and Liquidity” below and “Risk Factors” included in Part 1, Item 1A. of our 2017 Form 10-K for further discussion.

BUSINESS STRATEGY

Our overall strategy has been to manage our diverse asset base of residential, commercial, hotel and entertainment real estate located in the premier Austin, Texas market and in other select, fast-growing Texas markets. We enhance the value of our residential and commercial properties by securing and maintaining development entitlements and developing and building real estate projects on these properties for sale or investment. Our hotel and entertainment venues, including ACL Live, are located in downtown Austin and are central to the city's world renowned, vibrant music scene.
We are continuing our successful program of actively developing our properties and strategically marketing and selling developed assets at appropriate times to maximize stockholder value. Our active development plan includes completion of both residential and commercial projects. Our portfolio consists of approximately 1,700 acres of commercial, multi-family and single-family projects under development or undeveloped and held for future use. We believe that our portfolio, along with management’s extensive experience in Austin-area real estate development, support our ability to obtain project financing and/or seek joint venture partners including for the development projects described in “Development Activities - Residential” and “Development Activities - Commercial”.