AMERICAN REALTY INVESTORS INC
Form 10-Q
May 15, 2006

FORM 10-Q
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

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

FOR THE QUARTER ENDED MARCH 31, 2006
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 001-15663
AMERICAN REALTY INVESTORS, INC.
(Exact Name of Registrant as Specified in Its Charter)

Nevada	**75-2847135**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**

1800 Valley View Lane, Suite 300
Dallas, Texas 75234
(Address of principal executive offices)
(Zip Code)

(469) 522-4200
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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 x. No ¨.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes ¨. No x.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer in Rule 12b-2 of the Exchange Act (Check one):
Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x

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

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes ¨. No ¨.

APPLICABLE ONLY TO CORPORATE ISSUERS:

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	**10,895,972**
(Class)	**(Outstanding at March 31, 2006)**

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AMERICAN REALTY INVESTORS, INC.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

The accompanying Consolidated Financial Statements have not been audited by independent certified public accountants, but, in the opinion of the management of American Realty Investors, Inc. ("ARI"), all adjustments (consisting of normal recurring accruals) necessary for a fair presentation of ARI's consolidated financial position, consolidated results of operations and consolidated cash flows at the dates and for the periods indicated, have been included.

AMERICAN REALTY INVESTORS, INC.
CONSOLIDATED BALANCE SHEETS

	March 31, 2006	December 31, 2005
	(dollars in thousands)	
	(unaudited)	
Assets		
Real estate held for investment	$ 1,091,293	$ 1,025,661
Less—accumulated depreciation	(159,593)	(153,597)
	931,700	872,064
Real estate held for sale, net of depreciation	169,123	172,303
Real estate subject to sales contract	68,326	68,738
Notes and interest receivable		
Performing ($44,805 in 2006 and $44,500 in 2005 from affiliates)	61,347	70,894
Non-performing	11,546	11,546
	72,893	82,440
Less—allowance for estimated losses	(1,003)	(1,000)
	71,890	81,440
Restaurant equipment	13,981	13,911
Less—accumulated depreciation	(7,832)	(7,528)
	6,149	6,383
Marketable securities, at market value	7,936	7,446
Cash and cash equivalents	8,731	13,904
Investments in equity investees	13,660	13,521
Goodwill	11,858	11,858
Other intangibles, net of accumulated amortization ($616 in 2006 and $926 in 2005)	1,435	1,449
Other assets (including $32,535 in 2006 and $30,441 in 2005 due from affiliate)	104,898	96,689
	$ 1,395,706	$ 1,345,795

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

AMERICAN REALTY INVESTORS, INC.
CONSOLIDATED BALANCE SHEETS - Continued

	March 31, 2006 (unaudited)	December 31, 2005
	(dollars in thousands)	
Liabilities and Stockholders' Equity		
Liabilities:		
Notes payable ($44,845 in 2006 and $45,530 in 2005 to affiliates)	$ 853,040	$ 810,118
Interest payable ($1,046 in 2006 and $682 in 2005 to affiliates	8,750	7,826
Liabilities related to assets held for sale	153,124	144,555
Liabilities subject to sales contract	58,781	59,323
Stock-secured notes payable	22,549	22,549
Accounts payable and other liabilities ($238 in 2006 and $4,667 in 2005 to affiliates)	88,675	93,842
	1,184,919	1,138,213
Commitments and contingencies		
Minority interest	70,782	59,185
Stockholders' equity:		
Preferred Stock, $2.00 par value, authorized 50,000,000 shares, issued and outstanding		
Series A Cumulative Convertible Preferred Stock, 3,390,913 shares in 2006 and 2005 (liquidation preference $33,909), including 900,000 shares in 2006 and 2005 held by subsidiaries	4,982	4,982
Common Stock, $.01 par value, authorized 100,000,000 shares; issued 11,592,272 shares in 2006 and 2005	114	114
Treasury stock, at cost, 1,443,272 shares in 2006 and 2005	(15,146)	(15,146)
Additional paid-in capital	93,389	93,389
Retained earnings	56,116	64,805
Accumulated other comprehensive income (loss)	550	253
	140,005	148,397
	$ 1,395,706	$ 1,345,795

The accompanying notes are an integral part of these Consolidated Financial Statements

AMERICAN REALTY INVESTORS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

	For the Three Months Ended March 31, 2006	2005
	(dollars in thousands)	
Property revenue:		
Rental and other property revenues ($259 in 2006 and $182 in 2005 from affiliates)	$ 45,867	$ 37,758
Restaurant sales	9,349	8,620
Total operating revenues	55,216	46,378
Expenses:		
Property operating expenses ($1,923 in 2006 and $1,644 in 2005 to affiliates)	29,670	26,464
Restaurant cost of sales	6,915	6,754
Depreciation and amortization	6,726	5,572
General and administrative ($567 in 2006 and $899 in 2005 to affiliates)	3,892	2,736
Advisory fee to affiliate	3,081	2,906
Total operating expenses	50,284	44,432
Operating income (loss)	4,932	1,946
Other income (expense):		
Interest income from notes receivable ($657 in 2006 and $859 in 2005 from affiliates)	1,146	1,590
Gain on foreign currency transaction	2	—
Other income ($953 in 2006 from affiliate)	1,702	106
Mortgage and loan interest ($669 in 2006 and $501 in 2005 to affiliates)	(18,704)	(15,174)
Net income fee to affiliate	—	(1,477)
Total other income (expense)	(15,854)	(14,955)
Loss before gain on land sales, minority interest, and equity in earnings of investees	(10,922)	(13,009)
Gain on land sales	2,740	24,178
Minority interest	830	(921)
Equity in income (loss) of investees	175	60
Income (loss) from continuing operations	(7,177)	10,308
Income (loss) from discontinued operations	(898)	10,370
Net income (loss)	(8,075)	20,678
Preferred dividend requirement	(614)	(650)
Net income (loss) applicable to Common shares	$ (8,689)	$ 20,028

The accompanying notes are an integral part of these Consolidated Financial Statements

AMERICAN REALTY INVESTORS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS - Continued
(unaudited)

	For the Three Months Ended March 31, 2006	2005
	(dollars in thousands)	
Basic earnings per share:		
Income (loss) from continuing operations	$ (0.77)	$ 0.96
Income (loss) from discontinued operations	(0.09)	1.03
Net income (loss) applicable to Common shares	$ (0.86)	$ 1.98
Diluted earnings per share:		
Income (loss) from continuing operations	$ (0.77)	$ 0.75
Income (loss) from discontinued operations	(0.09)	0.81
Net income (loss) applicable to Common shares	$ (0.86)	$ 1.56
Weighted average Common shares used in computing earnings per share:		
Basic	10,149,000	10,149,000
Diluted	13,106,924	12,907,309

Series A Cumulative Convertible Preferred Stock (2,491,000 shares of Preferred Stock convertible into common stock estimated to be 2,957,000 common shares) and options to purchase 70,750 shares of ARI's common stock were excluded from the computation of diluted earnings per share for the three months ended March 31, 2006, because the effect of their inclusion would be antidilutive.

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

AMERICAN REALTY INVESTORS, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
For the Three Months Ended March 31, 2006
(dollars in thousands)
(unaudited)

	Series A Preferred Stock	Common Stock	Treasury Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income/(Loss)	Stockholders' Equity
Balance, January 1, 2006	$ 4,982	$ 114	$ (15,146)	$ 93,389	$ 64,805	$ 253	$ 148,397
Comprehensive income							
Unrealized gain on foreign currency translation	—	—	—	—	—	(193)	(193)
Unrealized gain on marketable securities	—	—	—	—	—	490	490
Net income	—	—	—	—	(8,075)	—	(8,075)
Repurchase of Preferred Stock	—	—	—	—	—	—	—
Preferred dividends							
Series A Cumulative Convertible Preferred Stock ($.25 per share)	—	—	—	¾	(614)	—	(614)
Balance, March 31, 2006	$ 4,982	$ 114	$ (15,146)	$ 93,389	$ 56,116	$ 550	$ 140,005

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

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AMERICAN REALTY INVESTORS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	For the Three Months Ended March 31 2006	For the Three Months Ended March 31 2005
	(dollars in thousands)	
Cash Flows From Operating Activities:		
Income (loss) from continuing operations	$ (7,177)	$ 10,308
Adjustments to reconcile net income to net cash used in operating activities		
Gain on sale of land and real estate	(2,740)	(24,178)
Depreciation and amortization	6,726	5,572
Amortization of deferred borrowing costs	1,209	2,072
Equity in (income) loss of investees	(175)	(60)
Gain on foreign currency transaction	(2)	¾
(Increase) decrease in accrued interest receivable	(427)	(336)
(Increase) decrease in other assets	(6,587)	4,496
Increase (decrease) in accrued interest payable	(70)	(888)
Increase (decrease) in minority interest	(36)	(261)
Increase (decrease) in other liabilities	5,292	(2,362)
Net cash used in operating activities	(3,987)	(5,637)
Cash Flows From Investing Activities:		
Collections on notes receivable	8,716	1,433
Proceeds from sale of notes receivable	¾	27,242
Funding of notes receivable	(2,670)	¾
Acquisition of real estate	(49,239)	(7,806)
Investment in real estate entities	(1,568)	¾
Real estate improvement	(4,655)	¾
Restaurant equipment purchased	(69)	(65)
Proceeds from sale of real estate	6,747	26,225
Notes receivable funded	¾	(647)
Earnest money/escrow deposits	(660)	(671)
Real estate improvements	¾	(16,350)
Distribution from equity investees	¾	406
Net cash provided by (used in) investing activities	(43,398)	29,767
Cash Flows From Financing Activities:		
Proceeds from notes payable	55,842	38,688
Payments on notes payable	(13,356)	(43,072)
Deferred borrowing costs	(2,568)	(1,212)
Net advances from (payments to) affiliates	3,482	(13,288)
Margin borrowings (payments), net	¾	(38)
Preferred dividends paid	(483)	(230)
Net cash (used in) provided by financing activities	42,917	(19,152)
Discontinued Operations		
Cash used in operating activities	(705)	¾
Cash provided by investing activities	¾	¾
Net cash provided (used) by discontinued operations	(705)	¾

Net increase (decrease) in cash and cash equivalents		(5,173)		17,291
Cash and cash equivalents, beginning of period		13,904		22,401
Cash and cash equivalents, end of period	$	8,731	$	39,692

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

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AMERICAN REALTY INVESTORS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS - Continued
(unaudited)

	For the Three Months Ended March 31, 2006		For the Three Months Ended March 31, 2005	
	(dollars in thousands)			
Supplemental Disclosures of Cash Flow Information:				
Cash paid for interest	$	18,301	$	17,068
Schedule of Non-Cash Investing and Financing Activities:				
Notes payable assumed from buyer upon sale of real estate	$	¾	$	14,422
Increase in minority interest related to acquisition of real estate		14,835		¾
Notes receivable from sale of real estate		¾		27,242
Acquisition of real estate to satisfy note receivable		¾		4,714
Note payable paid by affiliate		¾		700
Unrealized foreign currency translation gain (loss)		¾		706
Unrealized gain (loss) on marketable securities		¾		669

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

AMERICAN REALTY INVESTORS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION

The accompanying unaudited Consolidated Financial Statements have been prepared in conformity with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. Dollar amounts in tables are in thousands, except per share amounts. Certain balances for 2005 have been reclassified to conform to the 2006 presentation. Hereafter in this document, American Realty Investors, Inc. is referred to as ARI.

Operating results for the three month period ended March 31, 2006, are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. For further information on the basis of consolidation and accounting policies, refer to the Consolidated Financial Statements and Notes thereto included in ARI's Annual Report on Form 10-K for the year ended December 31, 2005 (the "2005 Form 10-K").

At December 31, 2005 and March 31, 2006, ARI subsidiaries owned 82.2% of the outstanding shares of Transcontinental Realty Investors, Inc. ("TCI"). At March 31, 2006, ARI and TCI have the same advisor (Prime Income Asset Management, LLC or "Prime") and Board of Directors.

At December 31, 2005 and March 31, 2006, ARI subsidiaries owned 20.4% of Income Opportunity Realty Investors, Inc. ("IORI") through TCI's ownership of 24.9% of IORI shares. Two directors of ARI also serve as directors of IORI.

Stock-based employee compensation. Effective January 1, 2006 (the "Effective Date"), the Company adopted SFAS No. 123-R using the modified prospective method. SFAS No. 123-R must be applied not only to newly awarded stock-options but also to previously awarded stock-options that were not fully vested on the Effective Date. All of ARI's stock-option grants were fully vested as of the Effective Date. Furthermore, ARI had no outstanding stock-option grants that were modified or settled after the Effective Date; therefore, subsequent to the Effective Date, ARI will recognize no additional compensation costs for previously awarded stock-option grants. In December 2005, the Company's Board of Directors terminated all stock-option plans and has no intent at the present to reinstate any stock-option programs.

NOTE 2. REAL ESTATE

In 2006, ARI purchased the following properties:

Property	Location	Sq. Ft./Acres	Purchase Price	Net Cash Paid	Debt Incurred	Interest Rate	Maturity Date
First Quarter							
Land							
Circle C Ranch	Austin, TX	1,092 Acres	$21,000	$ —	$21,000	8.75%[(1)]	03/08
Pioneer Crossing	Austin, TX	38.542 Acres	614[(2)]	614	1,515	8.75[(1)]	06/08
Southwood 1394	Tallahassee, FL	14.52 Acres	1,150	477	748	8.50[(1)]	02/08
Valley Ranch 20	Farmers Branch, TX	20 Acres	4,673	1,892	3,038	8.50[(1)]	02/08
Woodmont Fairway Office	Dallas, TX	5.866 Acres	3,833	1,014	3,000	8.25[(1)]	01/07

Woodmont Merit Drive	Dallas, TX	9.28 Acres	4,560	1,868	2,964	8.00	03/07
Apartments							
Anderson Estates Apts	Oxford, MS	48 Units	1,144 (3)	148	996	9.50 (1)	12/20
David Jordan Phase II	Greenwood, MS	32 Units	743 (3)	98	645	8.50 (1)	04/19
David Jordan Phase III	Greenwood, MS	40 Units	812 (3)	122	690	8.75 (1)	07/22
Leflore Estates / Curtis Moore Apartments	Greenwood, MS	104 Units	2,114 (3)	337	1,777	7.00	02/22
Monticello III Estates	Monticello, AR	32 Units	644 (3)	96	548	7.00	01/22
Riverwalk Phase I	Greenwood, MS	32 Units	455 (3)	99	356	8.50	02/19
Riverwalk Phase II	Greenwood, MS	72 Units	1,584 (3)	226	1,358	8.25 (1)	02/19

(1) Variable interest rate.

(2) Purchased from ARI; purchase price is equal to ARI's cost.

(3) Net of minority interest and other liabilities assumed.

AMERICAN REALTY INVESTORS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

In 2005, ARI purchased the following properties:

Property	Location	Units / Sq. Ft./Acres	Purchase Price	Net Cash Paid/ (Received)	Debt Incurred	Interest Rate	Maturity Date
First Quarter							
Land							
Katrina[1]	Palm Desert, CA	23.0 Acres	$4,184	$ —	$ —	—%	—
Keenan Bridge[2]	Farmers Branch, TX	7.5 Acres	510	14	—	—	—
Mandahl Bay	US Virgin Islands	50.8 Acres	7,000	4,101	3,500	7.00	07/05
Mandahl Bay (Gilmore)	US Virgin Islands	1.0 Acres	96	104	—	—	—
Mandahl Bay (Chung)	US Virgin Islands	.7 Acres	95	101	—	¾	—

(1) Exchanged for note receivable. See NOTE 3. "NOTES AND INTEREST RECEIVABLE."
(2) Exchanged for the Bee Street and 2524 Valley View land parcels.

In 2006, ARI sold the following properties:

Property	Location	Units/Acres/ Sq. Ft.	Sales Price	Net Cash Received/ (Paid)	Debt Discharged	Gain on Sale
First Quarter						
Land						
Hollywood Casino	Farmers Branch, TX	10.5 Acres	$3,225	$1,207	$—	$1,831
Vineyards II	Grapevine, TX	1.5 Acres	1,272	429	745	578
Second Quarter						
Land						
Elm Fork	Carrollton, TX	27.6 Acres	3,500	(827)	2,800	1,596
Nashville	Nashville, TN	16.4 Acres	2,512	—	2,416	1,700
Nashville	Nashville, TN	2.4 Acres	462	—	429	323

(1) Debt assumed by purchaser.

In 2005, ARI sold the following properties:

Property	Location	Units/Acres/ Sq. Ft.	Sales Price	Net Cash Received/ (Paid)	Debt Discharged	Gain on Sale
First Quarter						
Apartments						
Longwood	Long Beach, MS	200 Units	$6,456	$ 9	$6,253[1]	$56
Land						
Granbury Station	Ft. Worth, TX	15.7 Acres	1,003	265	738[1]	10
Katrina	Palm Desert, CA	9.9 Acres	2,616	574	—	1,323
Katrina	Palm Desert, CA	13.6 Acres	3,703	591	—	1,706
Katrina	Palm Desert, CA	5.5 Acres	1,325	1,281	—	619

Katrina	Palm Desert, CA	6.5 Acres	1,695	340	—	818
Katrina	Palm Desert, CA	7.4 Acres	2,028	455	—	1,072
Katrina	Palm Desert, CA	81.2 Acres	19,878	(814)	5,100	9,387
Katrina	Palm Desert, CA	24.8 Acres	6,402	1,027	—	2,947
Katy	Katy, TX	130.6 Acres	12,400	4,981	6,601	5,630
Nashville	Nashville, TN	1.2 Acres	304	236	—	226
Vista Ridge	Lewisville, TX	4.4 Acres	950	(92)	914	440

AMERICAN REALTY INVESTORS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Property	Location	Units/Acres/ Sq. Ft.	Sales Price	Net Cash Received/ (Paid)	Debt Discharged	Gain on Sale
Office Buildings						
Institute Place	Chicago, IL	144,915 Sq. Ft.	$14,460	$4,843	$7,792(1)	$10,603
Industrial Warehouses						
5700 Tulane	Atlanta, GA	67,850 Sq. Ft.	816	738	—	329

(1) Debt assumed by purchaser.

At March 31, 2006, ARI had the following apartment properties under construction:

Property	Location	Units	Amount Expended	Additional Amount to Expend	Construction Loan Funding
Laguna Vista	Farmers Branch, TX	206 Units	$8,662	$12,444	$17,741
Legends of El Paso	El Paso, TX	240 Units	5,793	12,290	16,040
Mission Oaks	San Antonio, TX	228 Units	13,458	4,011	15,636
Park at Maumelle	Maumelle, AR	240 Units	12,021	6,678	16,829
Park at Metro Center	Nashville, TN	144 Units	3,512	9,103	11,141

NOTE 3. NOTES AND INTEREST RECEIVABLE

In February 2005, ARI sold a 9.9 acre tract of its Katrina land parcel for $2.6 million, receiving $574,000 after payment of closing costs and providing purchase money financing of $2.0 million. The loan bore interest at 8.0%, required quarterly payments of interest, and matured in February 2008. In March 2005, ARI sold the loan for $2.0 million, receiving $2.0 million in cash after payment of closing costs.

In February 2005, ARI sold a 13.6 acre tract of its Katrina land parcel for $3.7 million, receiving $591,000 after payment of closing costs and providing purchase money financing of $2.8 million. The loan bore interest at 8.0%, required quarterly payments of interest, and matured in February 2008. In March 2005, ARI sold the loan for $2.8 million, receiving $2.8 million in cash after payment of closing costs.

In February 2005, ARI sold a 6.5 acre tract of its Katrina land parcel for $1.7 million, receiving $340,000 after payment of closing costs and providing purchase money financing of $1.3 million. The loan bore interest at 8.0%, required quarterly payments of interest, and matured in February 2007. In March 2005, ARI sold the loan for $1.3 million, receiving $1.3 million in cash after payment of closing costs.

In February 2005, ARI sold a 7.4 acre tract of its Katrina land parcel for $2.0 million, receiving $455,000 after payment of closing costs and providing purchase money financing of $1.5 million. The loan bore interest at 8.0%, required quarterly payments of interest, and matured in February 2007. In March 2005, ARI sold the loan for $1.5 million, receiving $1.5 million in cash after payment of closing costs.

In February 2005, ARI sold an 81.2 acre tract of its Katrina land parcel for $19.9 million, paying $814,000 after payment of debt and closing costs and providing purchase money financing of $14.9 million. The loan bore interest at 8.0%, required quarterly payments of interest, and matured in February 2007. In March 2005, ARI sold the loan for $14.9 million, receiving $14.9 million in cash after payment of closing costs.

In March 2005, ARI sold a 24.8 acre tract of its Katrina land parcel for $6.4 million, receiving $1.0 million after payment of closing costs and providing purchase money financing of $4.8 million. The loan bore interest at 8.0%, required quarterly payments of interest, and matured in March 2007. In March 2005, ARI sold the loan for $4.8 million, receiving $4.8 million in cash after payment of closing costs.

AMERICAN REALTY INVESTORS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

In March 2004, ARI sold an 8.0 acre tract of its Mason Goodrich land parcel for $1.0 million, receiving $251,000 after payment of closing costs and providing purchase money financing of $523,000. The secured loan bears interest at 10.0% per annum, requires monthly payments of accrued interest and matured in March 2006. All principal and accrued but unpaid interest is due at maturity. Through March 2006, $117,000 in principal has been collected. In March 2006, the purchaser extended the note to March 2007 by paying a 1% extension fee and making a 10% principal reduction.

In October 2004, ARI sold the In The Pines apartments to a third party and provided $1.0 million of the purchase price as seller financing in the form of two notes. The first note bore interest at 7.0% per annum, required monthly interest only payments, and matured in January 2005. The Purchaser extended this note to March 2005 by paying 1.0% of the outstanding principal balance as an extension fee and then extended the note an additional 30 days to April 2005 by paying an extension fee of 0.5% of the outstanding principal balance. In the event of a default, the note is also secured by membership rights in the purchaser's entity. The second note was unsecured, bore interest at 8.5% per annum, required monthly interest only payments, and matured in January 2005. The Purchaser extended this note to March 2005 by paying 1.0% of the outstanding principal balance as an extension fee and then extended the note an additional 30 days to April 2005 by paying an extension fee of 0.5% of the outstanding principal balance. Both loans were extended to October 2005 with the payment to ARI of a 2.0% extension fee. Both loans were paid in full, including unpaid interest, in October 2005.

In March 2005, ARI entered into an agreement to advance a third party $3.2 million for development costs relating to single-family residential lots in Austin, Texas. These advances are secured by membership interests in the borrower and a second lien on 1,092 acres of undeveloped land. The secured note bears interest at 10%, requires semi-annual interest payments, and matures in March 2008. In September 2005 the total amount authorized under this advance was increased to $5.0 million. As of March 31, 2006, ARI had advanced $3.2 million to the borrower. ARI also guaranteed, with full recourse to ARI, an $18 million bank loan for the borrower which is secured by a first lien on the 1,092 acres of undeveloped land. In June 2005, ARI purchased the subsidiary of a related party for $4.1 million that holds two notes receivable from this third party totaling $3.0 and $1.0 million, respectively. These notes are secured by approximately 142 acres of undeveloped land and membership interests in the borrowers. The secured notes bear interest at 12.0%, have an interest reserve for payments that is added to the principal balance on a monthly basis, and matured in June 2005. Both loans were extended to September 2005 and upon maturity, both loan balances were paid under the advance referred to at the beginning of this paragraph. In March 2006, ARI acquired all of the interests in the borrower, including ownership of the Austin, Texas land. The land is secured by the $18 million first mortgage and a $3 million subordinated loan. In March 2006, ARI secured a development loan of $31.277 million (secured by the Austin, Texas land), of which $18 million was used to pay the existing first mortgage. The development loan matures in March 2008 and bears interest at Prime + 1%. The Company intends to develop the land for sale to single-family residential builders.

In December 2005, ARI sold 27.192 acres and 3.73 acres to a third party for $10.1 million and $1.4 million, and provided $7.6 million and $1.0 million of seller financing, respectively. Both notes bear interest at 8.0% per annum, require monthly interest only payments, and mature in December 2008. In January 2006, ARI sold both notes to a financial institution for full face value less closing costs, plus accrued interest. The financial institution has a Put Option that would require ARI to purchase both notes back under the following conditions: (1) failure to construct agreed upon roads on the property by December 2006; (2) there occurs any event of default by the buyer; (3) certain escrow deposits for the road completion are not sufficient to cover the cost of the road construction; (4) any amendment, modification or assignment of certain development and escrow agreements between ARI and the buyer; and (5) failure of ARI to deliver certain documents to the financial institution within a timely manner. ARI and other related parties have also guaranteed the full payment of the note balances, including any outstanding interest and costs incurred by the financial institution.

In December 2004, ARI sold the Centura Tower office building to a partnership and retained a 1% non-controlling general partner interest and a 4% limited partner interest. ARI has certain obligations to fund the partnership for rent abatements, tenant improvements, leasing commissions and other cash shortfalls. Through March 31, 2006, ARI has funded $1.7 million of these obligations, and has recorded a note receivable from the partnership. This note has no maturity date, requires no payments, and bears interest at a fixed rate of 7.0% per annum. The note will be paid out of excess cash flow or from sales proceeds, but only after certain partner preferred returns are paid.

In March 2002, ARI sold the 174,513 Sq. Ft. Hartford Office Building in Dallas, Texas, for $4.0 million, providing $4.0 million in seller financing as well as an additional $1.4 million line of credit for leasehold improvements all in the form of a first lien mortgage note. The note bears interest at a variable interest rate, currently 7.5% per annum, requires monthly interest only payments and matures in March 2007. As of March 2006, ARI has funded $896,000 of the $1.4 million line of credit. ARI determined during the third quarter of 2005 that it would classify this note as non-performing due to the lack of debt payments received and the probability that no debt payments would be received in the future. Effective for the quarter ended September 30, 2005, ARI no longer accrues interest on this note. The loan is not considered impaired due to management's opinion that the fair value of the collateral is sufficient to cover the current loan balance and accrued interest at March 2006.

In July 2002, ARI entered into an agreement to fund up to $300,000 under a revolving line of credit secured by 100% interest in a partnership of the borrower. The line of credit bears interest at 12.0% per annum, requires monthly interest only payments, and matured in June 2005. This loan was extended to June 2006 in the second quarter of 2005 and was subsequently modified in the fourth quarter of 2005. This second modification extends the loan maturity to October 2007 and limits any advances under the line of credit to $25,000 per month. As of March 2006, the borrower had $211,000 of available credit under the credit limit.

AMERICAN REALTY INVESTORS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

In September 1999, in conjunction with the sale of two apartments in Austin, Texas, $2.1 million in purchase money financing was provided, secured by limited partnership interests in two limited partnerships owned by the buyer. In March 2000, the borrower made a $1.1 million payment. The borrower executed a replacement promissory note for the remaining note balance of $1.0 million, which was unsecured, non-interest bearing and matured in April 2003. In 2004, ARI initiated legal action to collect the note. In August 2005, a settlement agreement was reached. The note was replaced with a new promissory note, also non-interest bearing, which is secured by a $1.5 million Agreed Judgment. The note calls for 36 monthly payments beginning in January 2006, with a balloon payment of $460,000 due in January 2009. ARI will continue to classify this note as non-performing even though payments have been received in 2006.

In February 2003, ARI sold an 89.3 acre tract of its Katrina land parcel for $8.5 million, paying $410,000 after payment of closing costs and debt pay down and providing purchase money financing of $5.6 million. The note bears interest at 8.0% per annum and matures three years after the recording of the Deed of Trust. Interest was to begin accruing after improvements to the site were completed by ARI. The costs to ARI to complete the improvements, estimated to be $2.5 million, were accrued in 2002. By 2005 a portion of the improvements had been completed and the remaining accrual at March 31, 2006 is $1.2 million. At March 2006, negotiations with the buyer to settle the obligations were underway. The remaining improvements were not expected to be completed before the settlement. In April 2006 a proposal was made to a bank to sell the note at a discount, but still in excess of the note receivable balance less accrued development costs. The proposed bank note will be guaranteed by ARI and other related parties. The note is classified as non-performing at March 31, 2006.

In December 2002, ARI sold a 238.0 acre tract of its Desert Wells land parcel for $23.8 million, receiving $321,000 after payment of closing costs and debt paydown and providing purchase money financing of $21.4 million. The first lien financing of $17.8 million bore interest at 8.0% per annum, matured in December 2004, and required payments beginning in March 2003. In March 2003, the note was sold to an unrelated party for $17.1 million plus accrued and unpaid interest. The buyer of the note has limited recourse against a 53 acre parcel of ARI’s Katrina land, in event of default by the borrower. ARI recognized a previously deferred gain of $15.0 million upon completion of the sale of the note. The second lien financing of $3.6 million bore interest at 8.0% per annum and matured on March 31, 2003. All principal and interest were due at maturity. In February 2005, the note was exchanged for 23.0 acres of land in Palm Desert, California. See NOTE 2. “REAL ESTATE.”

Related Parties. In March 2004, ARI sold a K-Mart in Cary, North Carolina to Basic Capital Management ("BCM") for $3.2 million, including the assumption of debt. ARI also provided $1.5 million of the purchase price as seller financing. The unsecured note bears interest at 2.0% over the prime rate, currently 9.0% and matures in April 2008.

In March 2004, ARI sold the Texstar Warehouse in Arlington, Texas to BCM for $2.4 million, including the assumption of debt. ARI also provided $1.3 million of the purchase price as seller financing. The unsecured note bears interest at 2.0% over the prime rate, currently 9.0% and matures in April 2008.

NOTE 4. INVESTMENTS IN UNCONSOLIDATED REAL ESTATE ENTITIES

ARI’s investment in real estate entities at March 31, 2006, was as follows:

Investee	Percentage of ARI’s Ownership	Carrying Value of Investment	Market Value of Investment
IORI	24.88%	$ 6,155	$ 7,520

Garden Centura, L.P.	5.0%	6,048	¾
Other		351	$ 7,520
		$ 12,554	

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AMERICAN REALTY INVESTORS, INC.
NOTES TO FINANCIAL STATEMENTS - CONTINUED

Set forth below are summarized results of operations of IORI and Garden Centura for the three months ended March 31, 2006:

		2006
Revenues	$	5,775
Equity in loss of partnership		—
Property operating expenses		(2,205)
Depreciation		(873)
Interest		(1,506)
Income before gain on sale of real estate		1,191
Gain on sale of real estate		—
Net income		1,191

ARI's share of equity investees' income before gains on the sale of discontinued operations was $175,000 for the three months ended March 31, 2006. ARI did not recognize any gain on equity investees' sale of real estate for the three months ended March 31, 2006.

ARI's cash flow from IORI is dependent on IORI making distributions. In the fourth quarter of 2000, IORI suspended distributions.

NOTE 5. MARKETABLE EQUITY SECURITIES

ARI owns equity securities of Realty Korea CR-REIT Co., Ltd. No. 1 representing approximately a 9.2% ownership interest. This investment is considered an available-for-sale security. ARI recognized an unrealized gain of $490,000 for the three month period ending March 31, 2006 due to an increase in market price.

NOTE 6. NOTES PAYABLE

In March 2006, ARI, through one of its subsidiary companies, borrowed $11.75 million secured by approximately 235 acres of land in Austin, Texas. The loan is guaranteed by ARI, Prime and certain other affiliated companies. The loan bears interest at an annual rate of 12.5 percent and matured in April 2006. The loan is currently being extended.

In July 2005, ARI secured a line of credit for $10.0 million for the acquisition and financing of land tracts. The line of credit bears interest at the prime rate plus 1.0%, which is currently 8.0%, requires interest only payments, and matures in three years. Each land tract funding has a $2.0 million limit on the loan amount, requires interest only payments at the line of credit's variable rate, and has a maturity date of 18 months. The current amount available for use under the line of credit is $2.5 million.

In February 2005, ARI received a loan in the amount of $5.0 million. The note bears interest at 8.0% per annum, requires semi-annual interest payments, and matures in July 2006. The loan is collateralized by certain partnership interests that hold apartments owned by ARI. Anytime before maturity, the lender has the option to convert the outstanding loan balance into general and limited partnership units in each of the partnerships, subject to HUD approval.

In 2006, ARI financed/refinanced or obtained second mortgage financing on the following:

Property	Location	Sq. Ft./Rooms/ Units/Acres	Debt Incurred	Debt Discharged	Net Cash Received	Interest Rate	Maturity Date
First Quarter							
Apartments							
Hunters Glen	Midland, TX	212 Units	$2,475	$1,804	$421	7.23%(1)	02/09
Land							
Nashville	Nashville, TN	100.9 Acres	2,500	¾	2,500(2)	12.50	05/06
Palmer Lane	Austin, TX	367.4 Acres	14,000	14,300	(893)	8.50(1)	08/07
Pioneer Crossing	Austin, TX	235.0 Acres	11,750(3)	4,000	—	12.50	04/07
West End	Dallas, TX	5.3 Acres	9,000	2,000	6,079	8.00(1)	03/07

(1) Variable rate.

(2) Cash received by affiliate, increasing ARI’s affiliate receivable.

(3) Various affiliate notes extended and collateralized by ARI, increasing ARI affiliate receivable.

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AMERICAN REALTY INVESTORS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

In 2005, ARI financed/refinanced or obtained second mortgage financing on the following:

Property	Location	Sq. Ft./Rooms/ Units/Acres	Debt Incurred	Debt Discharged	Net Cash Received	Interest Rate	Maturity Date
First Quarter							
Land							
Nashville	Nashville, TN	109.6 Acres	$7,000	$—	$6,341	7.50 %	02/07
Shopping Centers							
Bridgeview Plaza	LaCrosse, WI	116,008 Sq. Ft.	7,197	6,304	649	7.25 (1)	03/10
Dunes Plaza	Michigan City, IN	223,869 Sq. Ft.	3,750	2,685	658	7.50 (1)	01/10

(1) Variable rate.

NOTE 7. STOCK-SECURED NOTES PAYABLE

ARI has margin arrangements with various financial institutions and brokerage firms, which provide for borrowings of up to 50.0% of the market value of marketable equity securities. ARI also has other notes payable secured by stock. The borrowings under such margin arrangements and notes are secured by the equity securities of IORI and TCI, and ARI's trading portfolio securities and bear interest rates ranging from 9.5% to 24.0% per annum. Stock-secured notes payable and margin borrowings totaled $22.5 million at March 31, 2006 and $22.5 million at December 31, 2005.

Sunset Management LLC. At March 31, 2006 and December 31, 2005, ARI's stock-secured notes payable include $5.0 million payable to Sunset Management LLC. On May 16, 2005, the United States District Court for the Northern District of Texas, Dallas Division, entered its Memorandum Opinion and Order and Judgment dismissing a purported stockholders' derivative action filed October 5, 2004, by Sunset Management LLC against a number of entities, including the Company, as Case No. 3:04-CV-02162-B styled Sunset Management LLC, derivatively on behalf of Transcontinental Realty Investors, Inc. v. American Realty Investors, Inc., et al. The Court's Judgment granted a Motion to Dismiss filed by the Defendants, including the Company, and ordered that Plaintiff Sunset Management LLC take nothing by its suit. No appeal was timely filed, and the dismissal of the action is now final. The Sunset Complaint in this case contained many of the same allegations raised by Sunset Management LLC in four other cases which, as rulings have occurred, have resulted in a denial of Sunset Management LLC's requested relief. The dismissed action was the fifth in a continuing series of actions involving Sunset Management LLC, certain subsidiaries of the Company and TCI resulting from a loan in September 2001 to BCM and three subsidiaries of the Company in the original amount of $30 million ($19.5 million of which bore interest at 24% per annum, while the remaining $10.5 million of which bore interest at 20%). In September 2002, $15 million in principal was repaid leaving a $15 million aggregate balance, which Sunset Management LLC orally agreed to extend the maturity date and accept substitute collateral, an arrangement which Sunset Management LLC did not honor, resulting in the original litigation filed in Texas State Court during October 2002 as Cause No. 02-09433-I in the 162nd Judicial District Court of Dallas County, Texas, originally styled American Realty Trust, Inc., ART Williamsburg, Inc., Basic Capital Management, Inc. and EQK Holdings, Inc. v. Sunset Management LLC (the "Texas Litigation"). The Texas Litigation alleged breach of contract, misrepresentation, breach of duty of good faith and fair dealing and slander of title by Sunset Management LLC and sought certain declaratory relief against Sunset Management LLC, as well as temporary and permanent anti-suit injunctions against Sunset Management LLC. The Texas Litigation has been removed to the United States Bankruptcy Court for the Eastern District of Texas, Sherman Division, as Adversary Proceeding No. 03-04256 styled American Realty Trust, Inc., et al. v. Sunset Management LLC, et al. This Adversary Proceeding is associated with the case styled In Re: ART Williamsburg, Inc., Debtor, pending in the United States Bankruptcy Court for the Eastern District of Texas, Sherman Division, Case No. 4:03-43909-BTR-11, filed August 22, 2003.

The Company is also a defendant in related litigation with Sunset Management LLC in the case styled Sunset Management LLC, et al. v. American Realty Investors, Inc., et al., now pending in the United States District Court for the Eastern District of Texas, Tyler Division, as Case No. 4:06-CV-18. In this case, Sunset Management LLC originally sought to require a conveyance by ARI and/or its subsidiaries of certain pledged shares back to the pledgors, BCM and certain subsidiaries of ARI. Sunset Management LLC has filed a Motion for Summary Judgment claiming that transfer of the ownership of the shares among the Company and its affiliates violates the pledge agreements. ARI has responded to the Motion, which it believes is without merit because the transfer of the shares harmed no one, did not affect the validity of the pledge agreements, and in fact, benefited not only ARI but also probably Sunset Management LLC because it substantially reduced the taxes payable on a consolidated basis for ARI and TCI, thereby potentially increasing the value of the collateral pledged. The Company expects this case to eventually be consolidated with the primary discussed in the preceding paragraph when that case is transferred to the district court.

AMERICAN REALTY INVESTORS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

Other Stock-secured notes payable. In September 2003, ARI obtained a security loan in the amount of $13.5 million from a financial institution. The loan bears interest at 12.0% over the 30-day LIBOR rate, currently 16.8% requires monthly payments of interest only and matured in September 2004. The loan is secured by 1,656,537 shares of TCI common stock and 250,000 shares of IORI common stock held by TCI. In September 2004, the maturity date was extended to December 2004. In December 2004, the maturity date was extended to March 2005. In March 2005, the maturity date was extended to March 2006. In March 2006, the maturity date was extended to March 2007.

NOTE 8. RELATED PARTY TRANSACTIONS

In March 2006, ARI, through one of its subsidiary companies, borrowed $11.75 million secured by approximately 235 acres of land in Austin, Texas. The loan is guaranteed by ARI, Prime and certain other affiliated companies. The loan bears interest at an annual rate of 12.5 percent and matured in April 2006. The loan is currently being extended.

In January 2005, an affiliate made a $700,000 note payment on ARI's behalf, reducing ARI's affiliate receivable.

During 2002, ARI's Board of Directors authorized ARI's Chief Financial Officer to advance funds either to or from ARI, through the advisor, in an amount up to $10.0 million and, subsequent to that, authorized ARI's Chief Financial Officer to make additional advances, on the condition that such advances shall be repaid in cash or transfers of assets within 90 days. These advances are unsecured, generally have not had specific repayment terms, and have been reflected in ARI's financial statements as other assets and other liabilities. Effective July 1, 2005, ARI and the advisor agreed to charge interest on the outstanding balance of funds advanced to or from ARI. The interest rate, set at the beginning of each quarter, is the prime rate plus 1% on the average daily cash balances advanced. Interest earned on the advances totaled $953,000 in 2006.

The following table reconciles the beginning and ending balances of accounts receivable from and (accounts payable to) affiliates as of March 31, 2006.

		PRIME
Balance, December 31, 2005	$	29,702
Cash transfers to affiliates		30,672
Cash transfers from affiliates		(36,680)
Advances through receipt of financing proceeds		10,250
Construction fees payable to affiliate		(527)
Balance, March 31, 2006	$	33,416

At March 31, 2006, ARI's other assets include $1.2 million due from affiliates for rent and interest. Also at March 31, 2006, ARI owed $711,000 million to Regis Property Management for management fees and sales commissions.

Returns on Metra Properties. In April 2002, ARI, TCI, and IORI sold 28 apartment properties to partnerships controlled by Metra Capital, LLC ("Metra"). Innovo Group, Inc. ("Innovo") is a limited partner in the partnerships that purchased the properties. Joseph Mizrachi, then a director of ARI, controlled approximately 11.67% of the outstanding common stock of Innovo. Management determined to treat the sales as financing transactions, and ARI and TCI continued to report the assets and the new debt incurred by Metra on their financial statements. The partnership agreements for each of these partnerships stated that the Metra Partners, as defined, receive cash flow distributions at least quarterly in an amount sufficient to provide them with a 15% cumulative compounded annual rate of return on their invested capital, as well as a cumulative compounded annual amount of 0.50% of the average outstanding balance of the mortgage indebtedness secured by any of these properties. These distributions to the Metra

Partners had priority over distributions to any other partners. In August 2004, ARI, TCI, and IORI instituted an action in Texas State District Court regarding the transaction. During April 2005, resolution of the litigation occurred, settling all liabilities remaining from the original partnership arrangements which included a return of investor equity, a cessation of any preferential return, prospective asset management fees and miscellaneous fees and transactions costs from the Plaintiffs as a prepayment of a preferred return, along with a delegation of management and corresponding payment of management fees to Prime, and a motion to dismiss the action as a part of the resolution. Of the prepayment, ARI recognized expense of $525,000 and a reduction in liabilities of $3.2 million during the second quarter of 2005.

AMERICAN REALTY INVESTORS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

NOTE 9. OPERATING SEGMENTS

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 net operating income and cash flow. Excluded from operating segment assets are assets of $134.7 million in 2006 and $137.7 million in 2005, which are not identifiable with an operating segment. There are no intersegment revenues and expenses, and ARI conducted all of its business within the United States, with the exception of Hotel Akademia (Poland), which began operations in 2002.

Presented below are ARI’s reportable segments’ operating income for the three months ended March 31, 2006 and 2005, and segment assets at March 31, 2006 and 2005.

For the Three Months Ended March 31, 2006	Commercial Properties	Apartments	Hotels	Land	Restaurants	Receivables/ Other	Total
Operating revenue	$ 15,810	$ 21,845	$ 7,792	$ 165	$ 9,349	$ 255	$ 55,216
Operating expenses	8,880	13,496	6,588	832	6,915	(126)	36,585
Depreciation	3,013	2,520	851	7	332	3	6,726
Mortgage and loan interest	3,825	7,994	1,248	4,227	327	1,083	18,704
Interest income	—	—	—	—	—	1,146	1,146
Gain on land sales	—	—	—	2,740	—	—	2,740
Segment operating income (loss)	$ 92	$ (2,165)	$ (895)	$ (2,161)	$ 1,775	$ 441	$ (2,913)
Capital expenditures	$ 2,153	$ 1,746	$ 250	$ 345	$ 69	$ —	$ 4,563
Assets	222,597	536,707	76,364	333,481	19,442	71,890	1,260,481
Property Sales:							
Sales price	$ —	$ —	$ —	$ 5,111	$ —	$ —	$ 5,111
Cost of sale	—	—	—	4,202	—	—	4,202
Recognized prior deferred gain	—	—	—	1,831	—	—	1,831
Gain on sale	$ —	$ —	$ —	$ 2,740	$ —	$ —	$ 2,740

For the Three Months Ended March 31, 2005	Commercial Properties	Apartments	Hotels	Land	Restaurants	Receivables/ Other	Total
Operating revenue	$ 12,037	$ 18,194	$ 7,313	$ 198	$ 8,620	$ 16	$ 46,378
Operating expenses	6,904	11,220	6,446	1,899	6,754	(17)	33,206
Depreciation	2,542	2,016	696	—	302	16	5,572
Mortgage and loan interest	2,918	6,408	1,546	2,875	348	1,095	15,190
Interest income	—	—	—	—	—	1,590	1,590
Gain on land sales	—	—	—	24,178	—	—	