

STRATUS PROPERTIES INC  
Form 10-Q  
August 09, 2007

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

**FORM 10-Q**

**(Mark One)**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended June 30, 2007**

**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: 0-19989**

**Stratus Properties Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**72-1211572**

(I.R.S. Employer Identification No.)

**98 San Jacinto Blvd., Suite 220**

**Austin, Texas**

(Address of principal executive offices)

**78701**

(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. R Yes No

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 and large accelerated filer" in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer

Accelerated filer

R

Non-accelerated filer

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

On June 30, 2007, there were issued and outstanding 7,568,416 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.  
CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)  
(In Thousands)

	June 30, 2007	December 31, 2006
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents, including restricted cash of \$114 and \$116, respectively	\$ 4,673	\$ 1,916
Accounts receivable	880	749
Deposits, prepaid expenses and other	3,844	3,691
Deferred tax asset	1,233	1,144
Discontinued operations	196	233
Total current assets	10,826	7,733
Real estate, commercial leasing assets and facilities, net:		
Property held for sale – developed or under development	121,320	116,865
Property held for sale – undeveloped	16,335	16,345
Property held for use, net	32,892	28,257
Investment in Crestview	3,800	3,800
Deferred tax asset	7,174	7,105
Other assets	4,242	4,094
Discontinued operations	19,447	19,751
Total assets	\$ 216,036	\$ 203,950
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 5,607	\$ 5,421
Accrued interest, property taxes and other	4,972	5,789
Current portion of long-term debt	320	311
Discontinued operations	428	1,068
Total current liabilities	11,327	12,589
Long-term debt	62,202	50,364
Other liabilities	6,122	6,957
Discontinued operations	94	94
Total liabilities	79,745	70,004
Stockholders' equity:		
Preferred stock	-	-
Common stock	81	81
Capital in excess of par value of common stock	190,740	188,873
Accumulated deficit	(41,677)	(42,655)
Common stock held in treasury	(12,853)	(12,353)
Total stockholders' equity	136,291	133,946
Total liabilities and stockholders' equity	\$ 216,036	\$ 203,950

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
<b>Revenues:</b>				
Real estate	\$ 5,317	\$ 31,714	\$ 9,743	\$ 42,752
Rental income	885	522	1,812	569
Commissions, management fees and other	760	285	981	550
<b>Total revenues</b>	<b>6,962</b>	<b>32,521</b>	<b>12,536</b>	<b>43,871</b>
<b>Cost of sales:</b>				
Real estate, net	3,406	11,684	4,989	19,231
Rental	856	299	1,519	425
Depreciation	323	251	623	290
<b>Total cost of sales</b>	<b>4,585</b>	<b>12,234</b>	<b>7,131</b>	<b>19,946</b>
General and administrative expenses	1,846	1,883	3,847	3,622
<b>Total costs and expenses</b>	<b>6,431</b>	<b>14,117</b>	<b>10,978</b>	<b>23,568</b>
<b>Operating income</b>	<b>531</b>	<b>18,404</b>	<b>1,558</b>	<b>20,303</b>
Interest expense, net	(329)	(240)	(659)	(300)
Interest income	56	188	585	202
<b>Income from continuing operations before income taxes</b>	<b>258</b>	<b>18,352</b>	<b>1,484</b>	<b>20,205</b>
(Provision for) benefit from income taxes	(65)	33	(515)	8,293
<b>Income from continuing operations</b>	<b>193</b>	<b>18,385</b>	<b>969</b>	<b>28,498</b>
Income (loss) from discontinued operations (including a gain on 7000 West sale of \$7,348 in the 2006 six-month period, net of taxes of \$486 in the second quarter of 2006 and \$2,414 in the 2006 six-month period)	48	(610)	10	7,453
<b>Net income</b>	<b>\$ 241</b>	<b>\$ 17,775</b>	<b>\$ 979</b>	<b>\$ 35,951</b>
<b>Basic net income (loss) per share of common stock:</b>				
Continuing operations	\$ 0.03	\$ 2.51	\$ 0.13	\$ 3.92
Discontinued operations	-	(0.08)	-	1.02
<b>Basic net income per share of common stock</b>	<b>\$ 0.03</b>	<b>\$ 2.43</b>	<b>\$ 0.13</b>	<b>\$ 4.94</b>
<b>Diluted net income (loss) per share of common stock:</b>				
Continuing operations	\$ 0.03	\$ 2.40	\$ 0.13	\$ 3.71
Discontinued operations	-	(0.08)	-	0.97
<b>Diluted net income per share of common stock</b>	<b>\$ 0.03</b>	<b>\$ 2.32</b>	<b>\$ 0.13</b>	<b>\$ 4.68</b>
<b>Average shares of common stock outstanding:</b>				
Basic	7,568	7,306	7,559	7,274
Diluted	7,690	7,660	7,680	7,679

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



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

	Six Months Ended June 30,	
	2007	2006
Cash flow from operating activities:		
Net income	\$ 979	\$ 35,951
Adjustments to reconcile net income to net cash provided by operating activities:		
Income from discontinued operations	(10)	(7,453)
Depreciation	623	290
Cost of real estate sold	5,358	20,700
Deferred income taxes	(158)	(8,293)
Stock-based compensation	759	679
Deposits	(358)	(2,753)
Other	(894)	(1,328)
(Increase) decrease in working capital:		
Accounts receivable and prepaid expenses	(332)	255
Accounts payable, accrued liabilities and other	(314)	(2,980)
Net cash provided by continuing operations	5,653	35,068
Net cash (used in) provided by discontinued operations	(304)	1,850
Net cash provided by operating activities	5,349	36,918
Cash flow from investing activities:		
Purchases and development of real estate properties	(17,143)	(12,375)
Development of commercial leasing properties and other expenditures	(334)	(6,134)
Municipal utility district reimbursements	2,557	1,328
Net cash used in continuing operations	(14,920)	(17,181)
Net cash provided by discontinued operations	-	3,988
Net cash used in investing activities	(14,920)	(13,193)
Cash flow from financing activities:		
Borrowings from revolving credit facility	15,450	15,000
Payments on revolving credit facility	(18,450)	(27,997)
(Payments on) borrowings from TIAA mortgage	(154)	22,800
Borrowings from unsecured term loans	15,000	-
Borrowings from project loans	-	2,236
Repayments on project loans	-	(20,402)
Net (payments for) proceeds from exercised stock options	(35)	752
Excess tax benefit from exercised stock options	655	-
Purchases of Stratus common shares	(153)	(505)
Bank credit facility fees	-	(421)
Net cash provided by (used in) continuing operations	12,313	(8,537)
Net cash used in discontinued operations	-	(6,461)
Net cash provided by (used in) financing activities	12,313	(14,998)
Net increase in cash and cash equivalents	2,742	8,727
Cash and cash equivalents at beginning of year	1,955	1,901



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Cash and cash equivalents at end of period	4,697	10,628
Less cash at discontinued operations	(24)	(4)
Less cash restricted as to use	(114)	(2,797)
Unrestricted cash and cash equivalents at end of period	\$ 4,559	\$ 7,827

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

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

**1. GENERAL**

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto for the year ended December 31, 2006, included in Stratus Properties Inc.'s (Stratus) Annual Report on Form 10-K (Stratus 2006 Form 10-K) filed with the Securities and Exchange Commission. In the opinion of management, the accompanying condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring items) considered necessary for a fair statement of the financial position of Stratus at June 30, 2007, and the results of operations for the three-month and six-month periods ended June 30, 2007 and 2006, and cash flows for the six-month periods ended June 30, 2007 and 2006. Operating results for the three-month and six-month periods ended June 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. Certain prior year amounts have been reclassified to conform to the current year presentation.

**2. EARNINGS PER SHARE**

Stratus' basic net income per share of common stock was calculated by dividing the income from continuing operations, income (loss) from discontinued operations and net income by the weighted average number of common shares outstanding during the period. The following is a reconciliation of net income and weighted average common shares outstanding for purposes of calculating diluted net income per share (in thousands, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Income from continuing operations	\$ 193	\$ 18,385	\$ 969	\$ 28,498
Income (loss) from discontinued operations	48	(610)	10	7,453
Net income	\$ 241	\$ 17,775	\$ 979	\$ 35,951
Weighted average common shares outstanding	7,568	7,306	7,559	7,274
Add: Dilutive stock options	97	314	100	360
Restricted stock	25	40	21	45
Weighted average common shares outstanding for purposes of calculating diluted net income per share	7,690	7,660	7,680	7,679
Diluted net income (loss) per share of common stock:				
Continuing operations	\$ 0.03	\$ 2.40	\$ 0.13	\$ 3.71
Discontinued operations	-	(0.08)	-	0.97
Diluted net income per share of common stock	\$ 0.03	\$ 2.32	\$ 0.13	\$ 4.68

**3. DEBT OUTSTANDING**

At June 30, 2007, Stratus had total debt of \$62.5 million, including \$0.3 million of current debt, compared to total debt of \$50.7 million, including \$0.3 million of current debt, at December 31, 2006. Stratus' debt outstanding at June 30, 2007 consisted of the following:

- \$40.0 million of borrowings outstanding under seven unsecured term loans, including two \$5.0 million loans, two \$8.0 million loans, a \$7.0 million loan and two \$3.5 million loans, all of which will mature in December 2011.

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- \$22.5 million related to the mortgage from the Teachers Insurance and Annuity Association of America (TIAA) associated with the Escarpment Village shopping center, which matures in July 2016.

On June 1, 2007, Stratus entered into three separate loan agreements with First American Asset Management (FAAM). Pursuant to the loan agreements, additional borrowings totaled \$15.0 million, \$10.6 million of which was used to pay down the outstanding amounts under Stratus' revolving credit facility with Comerica Bank, and the remainder will be used for operations, capital expenditures and other development costs, including the Block 21 Project. The loan agreements will mature in December 2011. The loan agreements contain customary financial covenants and other restrictions. Except in certain

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events related to a change in control of Stratus, the loans may not be prepaid prior to December 31, 2007. Beginning on January 1, 2008, the loans may be prepaid subject to certain reinvestment charges as further described in the related promissory notes. The annual interest rate under the loan agreements is 6.915 percent. Repayments under the loan agreements can be accelerated upon the occurrence of certain customary events of default. Stratus' obligations under the loan agreements are unsecured.

For a further discussion of Stratus' debt see Note 4 of the Stratus 2006 Form 10-K.

**4. RESTRICTED CASH, INTEREST COST AND STOCK-BASED COMPENSATION**

**Restricted Cash.** Restricted cash totaled \$0.1 million at June 30, 2007 and December 31, 2006, primarily representing funds held for payment of fractional shares resulting from the May 2001 stock split (see Note 6 of the Stratus 2006 Form 10-K).

**Interest Cost.** Interest expense excludes capitalized interest of \$0.7 million in the second quarter of 2007, \$0.5 million in the second quarter of 2006, \$1.3 million in the first six months of 2007 and \$1.4 million in the first six months of 2006.

**Stock-Based Compensation.** Stock-based compensation costs are capitalized as appropriate. Compensation cost charged against earnings for stock-based awards is shown below (in thousands).

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Stock options awarded to employees (including directors)	\$ 118	\$ 137	\$ 235	\$ 282
Stock options awarded to nonemployees	-	1	-	2
Restricted stock units	157	149	665	570
Less capitalized amounts	(43)	(56)	(141)	(175)
Impact on net income	\$ 232	\$ 231	\$ 759	\$ 679

Stock options representing 40,625 shares at a weighted average option price of \$7.66 per share were exercised in the first six months of 2007. The tax benefit realized for the tax deductions from stock option exercises totaled \$0.7 million for the six months ended June 30, 2007 and \$0.6 million for the six months ended June 30, 2006. Upon exercise of stock options and vesting of restricted stock units, employees may tender Stratus shares to Stratus to pay the exercise price and/or the minimum required taxes. Shares tendered to Stratus for these purposes totaled approximately 32,500 shares for the six months ended June 30, 2007. Stratus paid \$0.1 million of employee taxes for stock options in the six months ended June 30, 2007. Stratus granted 38,000 restricted stock units in the six months ended June 30, 2007, at a grant date fair value of \$1.3 million. For more information regarding Stratus' stock-based awards see Notes 1 and 6 of the Stratus 2006 Form 10-K.

**5. DISCONTINUED OPERATIONS**

Income (loss) from discontinued operations reported in the condensed consolidated statements of income included the following (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Income (loss) from discontinued operations:				

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7500 Rialto Boulevard	\$	48	\$	(124)	\$	10	\$	(248)
7000 West		-		(486)		-		7,701
Total	\$	48	\$	(610)	\$	10	\$	7,453

7500 Rialto Boulevard. In the second quarter of 2007, Stratus committed to a plan to sell its two 75,000-square-foot office buildings at 7500 Rialto Boulevard. The results of operations, assets and liabilities of 7500 Rialto Boulevard, which have been reclassified to discontinued operations in the accompanying condensed consolidated financial statements, previously represented a component of Stratus' commercial leasing segment.

The table below provides a summary of 7500 Rialto Boulevard's results of operations for the three-month and six-month periods ended June 30, 2007 and 2006 (in thousands):

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	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
Rental income	\$ 693	\$ 354	\$ 1,325	\$ 694
Rental property costs	(459)	(279)	(908)	(477)
Depreciation	(147)	(148)	(386)	(295)
Interest expense <sup>a</sup>	(10)	(51)	(13)	(170)
Provision for income taxes	(29)	-	(8)	-
Income (loss) from discontinued operations	\$ 48	\$ (124)	\$ 10	\$ (248)

a. Relates to interest expense from 7500 Rialto Boulevard project loan and does not include any additional allocations of interest.

The following summarizes 7500 Rialto Boulevard's net assets at June 30, 2007 and December 31, 2006 (in thousands):

	June 30, 2007	December 31, 2006
Assets:		
Cash and cash equivalents	\$ 24	\$ 39
Other current assets	172	194
Property held for sale, net of accumulated depreciation of \$2,542 and \$2,156, respectively	18,065	18,445
Other long-term assets	1,382	1,306
Liabilities:		
Other current liabilities	(428)	(1,068)
Other long-term liabilities	(94)	(94)
Net assets	\$ 19,121	\$ 18,822

7000 West. On March 27, 2006, Stratus' wholly owned subsidiary, Stratus 7000 West Joint Venture (7000 West JV), sold its two 70,000-square-foot office buildings at 7000 West William Cannon Drive (7000 West), known as the Lantana Corporate Center, to CarrAmerica Lantana, LP (CarrAmerica) for \$22.3 million, resulting in a gain of \$9.8 million (\$7.3 million net of taxes or \$1.01 per basic share and \$0.96 per diluted share) in the first six months of 2006. CarrAmerica paid \$10.6 million cash to Stratus at closing and assumed the \$11.7 million principal balance remaining under Stratus' 7000 West project loan.

Upon completion of the sale of 7000 West, Stratus ceased all involvement with the 7000 West office buildings. The results of operations, assets and liabilities of 7000 West previously were reflected as a component of Stratus' commercial leasing segment.

The table below provides a summary of 7000 West's results of operations for the three-month and six-month periods ended June 30, 2006 (in thousands):

	Three Months Ended	Six Months Ended
	June 30, 2006	June 30, 2006
Rental income	\$ -	\$ 1,057
Rental property costs	-	(403)
General and administrative expenses	-	(48)

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Interest expense <sup>a</sup>	-	(168)
Interest income	-	2
Gain on sale	-	9,762
Provision for income taxes	(486) <sup>b</sup>	(2,501)
(Loss) income from discontinued operations	)	)
	\$ (486	\$ 7,701

- a. Relates to interest expense from 7000 West project loan and does not include any additional allocations of interest.
- b. Reflects the allocation of Stratus' second-quarter 2006 tax provision to discontinued operations in accordance with income tax accounting rules.

For a further discussion of Stratus' discontinued operations see Note 7 of the Stratus 2006 Form 10-K.

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Stratus has two operating segments, "Real Estate Operations" and "Commercial Leasing." The Real Estate Operations segment is comprised of all Stratus' developed properties, properties under development and undeveloped properties in Austin, Texas, which consist of its properties in the Barton Creek community, the Circle C community and Lantana. The Deerfield property in Plano, Texas is also included in the Real Estate Operations segment.

The Commercial Leasing segment includes the Escarpment Village project and the two office buildings at 7500 Rialto Boulevard. Rental income from Escarpment Village totaled \$0.9 million in the second quarter of 2007 and \$1.8 million in the first six months of 2007, and \$0.5 million in each of the 2006 periods. In the second quarter of 2007, Stratus committed to a plan to sell its office buildings at 7500 Rialto Boulevard and their operating results are reported as discontinued operations for the periods in the table shown below (see Note 5). Stratus sold the two 70,000-square-foot office buildings at 7000 West in March 2006 and their operating results are reported as discontinued operations for the 2006 periods (see Note 5).

Stratus' lease agreement with the anchor tenant of Escarpment Village and its contract with Trammell Crow Central Texas, Ltd. (Trammell Crow), the firm managing Escarpment Village, contain provisions requiring Stratus to share the net profits from a sale of the project. The anchor tenant and Trammell Crow are each entitled to 10 percent of any net profit from a sale of Escarpment Village after Stratus receives a 12 percent return on its investment. Stratus paid the anchor tenant its net profits interest in December 2006 based upon a hypothetical sale at fair market value. Stratus is required to pay Trammell Crow its net profits interest upon a sale of the project, but no later than May 2008. If the project is not sold prior to the deadline, then the net profits calculation will be made based upon a hypothetical sale at fair market value. As of June 30, 2007, Stratus estimates the net profit payment due Trammell Crow will total \$0.7 million. The amount of the payment to the anchor tenant (\$0.7 million) and the estimated payment to Trammell Crow are recorded in other assets and are being amortized over the anchor tenant's lease term (20 years) as a reduction of rental income. The actual payment may vary from this amount and will be based on the actual sale price of Escarpment Village or the estimated fair value of Escarpment Village, as applicable (see Note 9).

The segment data presented below were prepared on the same basis as Stratus' consolidated financial statements.

	Real Estate Operations <sup>a</sup>	Commercial Leasing	Other	Total
	(In Thousands)			
<b>Three Months Ended June 30, 2007</b>				
Revenues	\$ 6,077	\$ 885	\$ -	\$ 6,962
Cost of sales, excluding depreciation	(3,406)	(856)	-	(4,262)
Depreciation	(38)	(285)	-	(323)
General and administrative expenses	(1,587)	(259)	-	(1,846)
Operating income (loss)	\$ 1,046	\$ (515)	\$ -	\$ 531
Income from discontinued operations	\$ -	\$ 48	\$ -	\$ 48
Provision for income taxes	\$ (65)	\$ -	\$ -	\$ (65)
Capital expenditures	\$ 7,967	\$ 212	\$ -	\$ 8,179
Total assets	\$ 145,473	\$ 61,768 <sup>b</sup>	\$ 8,795 <sup>c</sup>	\$ 216,036
<b>Three Months Ended June 30, 2006</b>				
Revenues	\$ 31,999	\$ 522	\$ -	\$ 32,521
Cost of sales, excluding depreciation	(11,684)	(299)	-	(11,983)
Depreciation	(34)	(217)	-	(251)
General and administrative expense	(1,694)	(189)	-	(1,883)
Operating income (loss)	\$ 18,587	\$ (183)	\$ -	\$ 18,404
Loss from discontinued operations	\$ -	\$ (610)	\$ -	\$ (610)



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Benefit from income taxes	\$	33	\$	-	\$	-	\$	33
Capital expenditures	\$	12,370	\$	6,038	\$	-	\$	18,408
Total assets	\$	126,117	\$	52,882 <sub>b</sub>	\$	8,150 <sub>c</sub>	\$	187,149

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	Real Estate Operations <sup>a</sup>	Commercial Leasing	Other	Total
	(In Thousands)			
<b>Six Months Ended June 30, 2007</b>				
Revenues	\$ 10,724	\$ 1,812	\$ -	\$ 12,536
Cost of sales, excluding depreciation	(4,989)	(1,519)	-	(6,508)
Depreciation	(70)	(553)	-	(623)
General and administrative expenses	(3,308)	(539)	-	(3,847)
Operating income (loss)	\$ 2,357	\$ (799)	\$ -	\$ 1,558
Income from discontinued operations	\$ -	\$ 10	\$ -	\$ 10
Provision for income taxes	\$ (515)	\$ -	\$ -	\$ (515)
Capital expenditures	\$ 17,143	\$ 334	\$ -	\$ 17,477
<b>Six Months Ended June 30, 2006</b>				
Revenues	\$ 43,302	\$ 569	\$ -	\$ 43,871
Cost of sales, excluding depreciation	(19,231)	(425)	-	(19,656)
Depreciation	(67)	(223)	-	(290)
General and administrative expense	(3,303)	(319)	-	(3,622)
Operating income (loss)	\$ 20,701	\$ (398)	\$ -	\$ 20,303
Income from discontinued operations	\$ -	\$ 7,453 <sup>d</sup>	\$ -	\$ 7,453
Benefit from income taxes	\$ 8,293	\$ -	\$ -	\$ 8,293
Capital expenditures	\$ 18,409	\$ 6,134	\$ -	\$ 24,543

- a. Includes sales commissions, management fees and other revenues together with related expenses.
- b. Includes assets from the discontinued operations of 7500 Rialto Boulevard, which Stratus currently has plans to sell, totaling \$19.6 million, net of accumulated depreciation of \$2.5 million, at June 30, 2007, and \$16.4 million, net of accumulated depreciation of \$1.7 million, at June 30, 2006 (see Note 5).
- c. Includes deferred tax assets resulting from the reversal of a portion of Stratus' deferred tax asset valuation allowance which was recorded as a benefit from income taxes (see Note 7).
- d. Includes a \$7.3 million gain, net of taxes of \$2.4 million, on the sale of 7000 West.

## 7. INCOME TAXES

Stratus' deferred tax assets at December 31, 2005 totaled \$19.5 million. At the time, Stratus had provided a 100 percent valuation allowance because realization of the deferred tax assets was not considered likely. Realization of Stratus' deferred tax assets is dependent on generating sufficient taxable income within the carryforward period available under tax law. In March 2006, Stratus sold 7000 West (see Note 5) and in April 2006, Stratus completed the sale of 58 acres at Lantana. These transactions generated pre-tax income of approximately \$26 million and, along with Stratus' current homebuilder contract arrangements and projected levels of future sales, provide sufficient evidence that Stratus will more likely than not be able to realize all of its deferred tax assets. As a result, income from continuing operations for the first six months of 2006 included an \$8.3 million, \$1.14 per basic share and \$1.08 per diluted share, tax benefit resulting from the reversal of a portion of our deferred tax asset valuation allowance. Stratus' provision for income taxes for the six months ended June 30, 2007 totaled \$0.5 million, \$0.07 per share.

Effective January 1, 2007, Stratus adopted Financial Accounting Standards Board (FASB) Interpretation No. 48 "Accounting for Uncertainty in Income Taxes" (FIN 48). FIN 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition issues. The adoption of FIN 48 had no material effect on Stratus' financial statements. Stratus will recognize interest accrued related to unrecognized tax benefits in

interest expense and penalties in non-operating expenses.

Stratus files income tax returns in the U.S. federal jurisdiction and various state and local jurisdictions. With few exceptions, Stratus is no longer subject to U.S. federal or state and local income tax examinations by tax authorities for the years prior to 2003. Recently, the Texas Comptroller of Public Accounts (the Comptroller) notified Stratus of their plan to conduct a routine audit of Stratus' Texas Franchise Tax account. Stratus anticipates that the Comptroller will complete this examination by the end of 2007. Stratus does not anticipate that adjustments resulting from this examination, if any, would result in a material change to its financial position or results of operations.

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**8. NEW ACCOUNTING STANDARDS**

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, "Fair Value Measurements." SFAS No. 157 establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), clarifies the definition of fair value within that framework, and expands disclosures about the use of fair value measurements. In many of its pronouncements, the FASB has previously concluded that fair value information is relevant to the users of financial statements and has required (or permitted) fair value as a measurement objective. However, prior to the issuance of this statement, there was limited guidance for applying the fair value measurement objective in GAAP. This statement does not require any new fair value measurements in GAAP. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007, with early adoption allowed. Stratus is still reviewing the provisions of SFAS No. 157 and has not determined the impact of adoption.

In February 2007, the FASB issued SFAS No. 159 "The Fair Value Option for Financial Assets and Liabilities – Including an amendment of FASB No. 115." SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. This statement is effective for fiscal years beginning after November 15, 2007, with early adoption allowed. Stratus has not yet determined the impact, if any, that adopting this standard might have on its financial statements.

**9. SUBSEQUENT EVENT**

In July 2007, through an unsolicited offer, Christopher Investment Company, Inc. initiated discussions with Stratus regarding a potential sale of Escarpment Village. Escarpment Village is a component of Stratus' commercial leasing segment. Effective July 19, 2007, Stratus' wholly owned subsidiary, Escarpment Village, L.P., entered into a Purchase and Sale Agreement (the Agreement) with Christopher Investment Company, Inc. (the Purchaser), under which Stratus agreed to sell Escarpment Village for approximately \$46.6 million. The Purchaser has deposited \$500,000 in an escrow account, which will be credited to the purchase price payable at closing. Both parties have agreed to a review period during which the Purchaser has the right to inspect the property and conduct due diligence and may elect to terminate the Agreement. The Agreement contains customary covenants, representations and warranties. Subject to customary closing conditions, including the Purchaser's assumption of Stratus' \$22.8 million loan from TIAA, the sale is expected to close by the fourth quarter of 2007. The \$500,000 escrow deposit is refundable during the review period and in the event TIAA fails to approve the Purchaser's assumption of the TIAA loan. The sale of this property is subject to the Agreement; and except for the activities related to the Agreement, Stratus is not marketing the sale of Escarpment Village.

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REVIEW BY INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The financial information as of June 30, 2007, and for the three-month and six-month periods ended June 30, 2007 and 2006, included in Part I of this Form 10-Q pursuant to Rule 10-01 of Regulation S-X has been reviewed by PricewaterhouseCoopers LLP (PricewaterhouseCoopers), Stratus' independent registered public accounting firm, in accordance with the standards of the Public Company Accounting Oversight Board (United States). PricewaterhouseCoopers' report is included in this quarterly report.

PricewaterhouseCoopers does not carry out significant or additional procedures beyond those that would have been necessary if its report had not been included in this quarterly report. Accordingly, such report is not a "report" or "part of a registration statement" within the meaning of Sections 7 and 11 of the Securities Act of 1933 and the liability provisions of Section 11 of such Act do not apply.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders  
of Stratus Properties Inc.:

We have reviewed the accompanying condensed consolidated balance sheet of Stratus Properties Inc. and its subsidiaries as of June 30, 2007 and the related condensed consolidated statements of income for each of the three-month and six-month periods ended June 30, 2007 and 2006 and the condensed consolidated statements of cash flows for the six-month periods ended June 30, 2007 and 2006. These interim financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We previously audited in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2006, and the related consolidated statements of income, of changes in stockholders' equity and of cash flows for the year then ended (not presented herein), and in our report dated March 15, 2007, we expressed an unqualified opinion on those consolidated financial statements with an explanatory paragraph for the Company's change in accounting for stock-based compensation. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet information as of December 31, 2006, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

**/s/ PricewaterhouseCoopers LLP**

Austin, Texas

August 8, 2007

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

**OVERVIEW**

*Management's discussion and analysis presented below should be read in conjunction with our discussion and analysis of financial results contained in our 2006 Annual Report on Form 10-K (2006 Form 10-K). The operating results summarized in this report are not necessarily indicative of our future operating results. All subsequent references to Notes refer to Notes to Condensed Consolidated Financial Statements, unless otherwise stated.*

We are engaged in the acquisition, development, management and sale of commercial, multi-family and residential real estate properties located primarily in the Austin, Texas area. We conduct real estate operations on properties we own.

Our principal real estate holdings are currently in southwest Austin, Texas. As of June 30, 2007, our most significant holding is the 1,728 acres of residential, multi-family and commercial property and 27 developed residential estate lots located within the Barton Creek community. We also own approximately 350 acres of undeveloped commercial property and approximately 36 acres of commercial property under development within the Circle C Ranch (Circle C) community. Our other properties in the Circle C community currently include Meridian, which is an 800-lot residential development, and Escarpment Village, which is a 168,000-square-foot retail center anchored by a grocery store. At June 30, 2007, Meridian consisted of approximately 282 acres and 40 developed residential lots. Our remaining Austin holdings at June 30, 2007, consisted of 223 acres of commercial property and two 75,000-square-foot office buildings at 7500 Rialto Boulevard located in Lantana. In the second quarter of 2007, we committed to a plan to sell the office buildings at 7500 Rialto Boulevard and we have reported its assets, liabilities and results of operations as discontinued operations.

At June 30, 2007, our Deerfield property, which is located in Plano, Texas, consists of approximately eight acres of residential land, which is being developed, and 34 developed residential lots. We also own two acres of undeveloped commercial property in San Antonio, Texas.

In November 2005, we formed a joint venture with Trammell Crow Central Texas Development, Inc. (Trammell Crow) to acquire an approximate 74-acre tract at the intersection of Airport Boulevard and Lamar Boulevard in Austin, Texas for \$7.7 million. The property, known as Crestview Station, is a single-family, multi-family, retail and office development. With Trammell Crow, we have commenced brown field remediation and permitting of the property.

In December 2006, we acquired a city block in downtown Austin for \$15.1 million. The project, known as Block 21, is planned for a mixture of retail, hotel, residential, and entertainment uses on approximately two acres as more fully discussed in "Development and Other Activities."

**BUSINESS STRATEGY**

Our financial condition and results of operations are highly dependent upon market conditions in Austin. Our future operating cash flows and, ultimately, our ability to develop our properties and expand our business will be largely dependent on the level of our real estate sales. In turn, these sales will be significantly affected by future real estate market conditions in Austin, Texas, development costs, interest rate levels and regulatory issues including our land use and development entitlements. From 2001 through 2004, a downturn in the technology sector negatively affected the Austin real estate market, especially the high-end residential and commercial leasing markets; however, beginning in 2005, market conditions have improved.

Over the past several years, we have successfully worked cooperatively with the City of Austin (the City) to obtain approvals that allow the development of our properties to proceed in a timely manner while protecting the environment. We believe the desirable location and overall quality of our properties, in combination with the land use and development entitlements we have obtained, will command a premium over the value of other Austin-area properties.

Our long-term success will depend on our ability to maximize the value of our real estate through obtaining required approvals that permit us to develop and sell our properties in a timely manner at a reasonable cost. We must incur significant development expenditures and secure additional permits prior to the development and sale of certain properties. In addition, we continue to pursue additional development

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opportunities, and believe we can obtain bank financing for developing our properties at a reasonable cost. See “Risk Factors” located in Item 1A. of our 2006 Form 10-K.

As previously announced, we were exploring strategic alternatives for enhancing shareholder value, including a possible sale of the company. We retained JPMorgan as our financial advisor to assist in this process. We have terminated the process of exploring the possible sale of the company but expect to continue to review various alternatives to enhance shareholder value.

## **DEVELOPMENT AND OTHER ACTIVITIES**

*Block 21.* In April 2005, the City selected our proposal to develop a mixed-use project in downtown Austin immediately north of the new City Hall complex. The project includes an entire city block and is planned for a mixture of retail, hotel, residential and entertainment uses. In December 2006, we acquired the property for \$15.1 million. We have executed agreements with Starwood Hotels & Resorts Worldwide, Inc. for the development of a W Hotel and Residences on the site. In addition, we have agreements for the new studio for KLRU’s “Austin City Limits” program and for the Austin Children’s Museum. On May 8, 2007, Stratus announced its partnership with Canyon-Johnson Urban Fund II, L.P., a joint venture between the Los Angeles-based Canyon Capital Realty Advisors and Earvin "Magic" Johnson, for the development of Block 21. We have begun the permitting process with the City and expect construction to begin by the fourth quarter of 2007.

*Lantana.* Lantana is a partially developed, mixed-use project with remaining entitlements for approximately 1.0 million square feet of office and retail use on 223 acres as of June 30, 2007. Regional utility and road infrastructure is in place with capacity to serve Lantana at full build-out permitted under our existing entitlements.

In September 2006, we completed a second 75,000-square-foot office building at 7500 Rialto Boulevard in response to increased demand for office space within Lantana. As of June 30, 2007, we had leased approximately 50 percent of the space at the second office building and approximately 96 percent of the original office building. In the second quarter of 2007, we committed to a plan to sell the office buildings at 7500 Rialto Boulevard and we have reported its assets, liabilities and results of operations as discontinued operations. We sold our two 7000 West office buildings in March 2006 (see Note 5).

*Barton Creek Community.* Since January 2002, we have secured subdivision plat approval for three new residential subdivisions within the Barton Creek Community, including: Versant Place – 54 lots, Wimberly Lane Phase II – 47 lots and Calera – 155 lots. At June 30, 2007, our remaining unsold developed lots within the Barton Creek Community included: Calera Drive – 8 lots, Wimberly Lane Phase II – 8 lots, Calera Court – 8 lots and Mirador – 3 lots. Development of the remaining Barton Creek property is expected to occur over several years.

In 2004, we entered into a contract with a national homebuilder to sell 41 lots within the Wimberly Lane Phase II subdivision in the Barton Creek community. The homebuilder paid us a non-refundable \$0.6 million deposit for the right to purchase the 41 lots. The deposit was used to pay ongoing development costs of the lots. The deposit will be applied against subsequent purchases of lots by the homebuilder after certain thresholds are achieved and will be recognized as income as lots are sold. The lots are being sold on a scheduled takedown basis, with the initial six lots sold in December 2004 following completion of subdivision utilities, and then an average of three lots per quarter beginning in June 2005. The average purchase price for each of the 41 lots is \$150,400, subject to a six percent annual escalator commencing in December 2004.

During 2004, we began construction of courtyard homes at Calera Court within the Barton Creek community. Calera Court, the initial phase of the “Calera” subdivision, will include 16 homesites on 16 acres. The second phase of Calera, Calera Drive, consisting of 53 single-family lots, many of which adjoin the Fazio Canyons Golf Course, received final

plat and construction permit approval in 2005. In the third quarter of 2005, development of these lots was completed and the initial lots were sold. As of June 30, 2007, only 8 lots remained unsold at Calera Drive. Development of the final phase, known as Verano Drive, will include 71 single-family lots. Construction of the final phase of Calera began in the first quarter of 2007 and is scheduled for completion in December 2007.

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*Circle C Community.* We have commenced development activities at the Circle C community based on the entitlements secured in our Circle C settlement with the City. Our Circle C settlement, as amended in 2004, permits development of 1.16 million square feet of commercial space, 504 multi-family units and 830 single family residential lots. Meridian is an 800-lot residential development at the Circle C community. In January 2005, the first phase of construction commenced. During the first quarter of 2005, we contracted to sell a total of 494 lots in our Meridian project to three national homebuilders in four phases. Sales for each of the four phases commence upon substantial completion of development for that phase, and continue every quarter until all of the lots have been sold. The first and second phases each consisted of 134 lots. The first phase was substantially completed at the end of 2005. Development of the second phase commenced in the third quarter of 2005 and was substantially completed in March 2006. Development of the 108-lot third phase of Meridian has commenced and is expected to be completed by September 2007. The 118-lot fourth phase will commence by the end of 2007 and completion is expected in 2008.

In 2006, we signed another contract with a national homebuilder for 42 additional lots. Development of those lots commenced in April 2007 and substantial completion is expected in November 2007. Development of the final phase of Meridian, which consists of 57 one-acre lots, is expected to commence in 2008.

We estimate our sales from the first two phases of Meridian will total at least 26 lots for \$1.8 million during the third quarter of 2007.

The grand opening of Escarpment Village, a 168,000-square-foot retail project anchored by a grocery store at the Circle C community, was in May 2006. As of June 30, 2007, we had leases for approximately 151,600 square feet or 90 percent of the space at Escarpment Village. In July 2007, through an unsolicited offer, Christopher Investment Company, Inc. initiated discussions with us regarding a potential sale of Escarpment Village. Escarpment Village is a component of our commercial leasing segment. Effective July 19, 2007, our wholly owned subsidiary, Escarpment Village, L.P., entered into a Purchase and Sale Agreement (the Agreement) with Christopher Investment Company, Inc. (the Purchaser), under which we have agreed to sell Escarpment Village for approximately \$46.6 million. The Purchaser has deposited \$500,000 in an escrow account, which will be credited to the purchase price payable at closing. Both parties have agreed to a review period during which the Purchaser has the right to inspect the property and conduct due diligence and may elect to terminate the Agreement. The Agreement contains customary covenants, representations and warranties. Subject to customary closing conditions, including the Purchaser's assumption of our \$22.8 million loan from Teachers Insurance and Annuity Association of America (TIAA), the sale is scheduled to close by the fourth quarter of 2007. The \$500,000 escrow deposit is refundable during the review period and in the event TIAA fails to approve the Purchaser's assumption of the TIAA loan. The sale of this property is subject to the Agreement; and except for activities related to the Agreement, we are not marketing the sale of Escarpment Village.

*Deerfield.* In January 2004, we acquired the Deerfield property in Plano, Texas, for \$7.0 million. The property was zoned and subject to a preliminary subdivision plan for 234 residential lots. We executed agreements with a national homebuilder, whereby the homebuilder paid us \$1.4 million for an option to purchase all 234 lots over 36 monthly take-downs. The net purchase price for each of the 234 lots was \$61,500, subject to certain terms and conditions. The \$1.4 million option payment is non-refundable, but will be applied against subsequent purchases of lots by the homebuilder after certain thresholds are achieved and will be recognized by us as income as lots are sold. We agreed to pay up to \$5.2 million of the homebuilder's development costs. The homebuilder must pay all property taxes and maintenance costs. The initial lot sale occurred in November 2004 and subsequent lot sales are on schedule. In October 2005, we executed a revised agreement with the homebuilder, increasing the lot sizes and average purchase price to \$67,150 based on a new total of 224 lots. We expect 15 lot sales for \$1.0 million to be completed during the third quarter of 2007.

*Crestview Station.* In November 2005, we formed a joint venture with Trammell Crow to acquire an approximate 74-acre tract at the intersection of Airport Boulevard and Lamar Boulevard in Austin, Texas, for \$7.7 million. With

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Trammell Crow, we have commenced brown field remediation and permitting of the property, known as Crestview Station, which is located on the commuter rail line approved by City of Austin voters. Crestview Station is planned for single-family, multi-family and retail development, with closings on the single-family and multi-family components and portions of the retail component expected to occur in 2007, subject to completion of the remediation process. At June 30, 2007, our investment in

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the Crestview Station project totaled \$3.8 million and the joint venture partnership had \$7.6 million of outstanding debt, of which each joint venture partner guarantees \$1.9 million.

Our joint venture partnership has contracted with a nationally recognized remediation firm to demolish the existing buildings and remediate the property in preparation for permitting. Under the terms of the remediation contract, the joint venture partnership will pay the contractor approximately \$4.9 million upon completion of performance benchmarks and certification by the State of Texas that the remediation is complete. The contractor is required to pay all costs associated with the remediation and to maintain an environmental liability policy with \$10.0 million of coverage remaining in place for a 10-year term. Pursuant to the agreement with the contractor, all environmental and legal liability was assigned to and assumed by the contractor effective November 30, 2005.

### RESULTS OF OPERATIONS

We are continually evaluating the development potential of our properties and will continue to consider opportunities to enter into significant transactions involving our properties. As a result, and because of numerous other factors affecting our business activities as described herein, our past operating results are not necessarily indicative of our future results.

Summary operating results follow (in thousands):

	Second Quarter		Six Months	
	2007	2006	2007	2006
Revenues:				
Real estate operations	\$ 6,077	\$ 31,999	\$ 10,724	\$ 43,302
Commercial leasing	885	522	1,812	569
Total revenues	\$ 6,962	\$ 32,521	\$ 12,536	\$ 43,871
Operating income	\$ 531	\$ 18,404	\$ 1,558	\$ 20,303
(Provision for) benefit from income taxes	\$ (65)	\$ 33	\$ (515)	\$ 8,293
Income from continuing operations	\$ 193	\$ 18,385	\$ 969	\$ 28,498
Income (loss) from discontinued operations	48	) (610	10	7,453
Net income	\$ 241	\$ 17,775	\$ 979	\$ 35,951

Our deferred tax assets at December 31, 2005 totaled \$19.5 million and we had provided a 100 percent valuation allowance because realization of the deferred tax assets was not considered likely. Realization of our deferred tax assets is dependent on generating sufficient taxable income within the carryforward period available under tax law. In March 2006, we sold 7000 West (see Note 5) and in April 2006, we completed the sale of 58 acres at our Lantana property. These transactions generated pre-tax income of approximately \$26 million and, along with our current homebuilder contract arrangements and projected levels of future sales, provide sufficient evidence that we will more likely than not be able to realize all of our deferred tax assets. As a result, income from continuing operations for the first six months of 2006 included an \$8.3 million, \$1.14 per basic share and \$1.08 per diluted share, tax benefit resulting from the reversal of a portion of our deferred tax asset valuation allowance.

We have two operating segments, "Real Estate Operations" and "Commercial Leasing" (see Note 6). The following is a discussion of our operating results by segment.

**Real Estate Operations**

Summary real estate operating results follow (in thousands):

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	Second Quarter		Six Months	
	2007	2006	2007	2006
Revenues:				
Developed property sales	\$ 5,317	\$ 10,969	\$ 8,660	\$ 20,507
Undeveloped property sales	-	20,745	1,083	22,245
Commissions, management fees and other	760	285	981	550
Total revenues	6,077	31,999	10,724	43,302
Cost of sales, including depreciation	(3,444)	(11,718)	(5,059)	(19,298)
General and administrative expenses	(1,587)	(1,694)	(3,308)	(3,303)
Operating income	\$ 1,046	\$ 18,587	\$ 2,357	\$ 20,701

*Developed Property Sales.* Property sales for the second-quarter and six-month periods of 2007 and 2006 included the following (revenues in thousands):

	Second Quarter			
	2007		2006	
	Lots	Revenues	Lots	Revenues
<i>Residential Properties:</i>				
Barton Creek				
Calera Drive	2	\$809	12	\$4,952
Mirador Estate	2	1,559	3	1,688
Wimberly Lane Phase II				
Standard Homebuilder Estate	3	522	3	482
Circle C				
Meridian	20	1,423	43	2,504
Deerfield	15	1,004	20	1,343
Total Residential	42	\$5,317	81	\$10,969

	Six Months			
	2007		2006	
	Lots	Revenues	Lots	Revenues
<i>Residential Properties:</i>				
Barton Creek				
Calera Drive	2	\$809	18	\$7,854
Calera Court Courtyard Homes	-	-	4	2,312
Mirador Estate	2	1,559	5	2,753
Wimberly Lane Phase II				
Standard Homebuilder Estate	6	1,045	5	783
Circle C				
Meridian	48	3,239	82	4,791
Deerfield	30	2,008	30	2,014

Total Residential	88	\$8,660	144	\$20,507
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*Undeveloped Property Sales.* We sold a five-acre tract at Circle C for \$1.1 million during the first quarter of 2007 and a 7.5-acre tract in the Barton Creek community for \$1.5 million during the first quarter of 2006. In April 2006, we sold a 58-acre tract at Lantana for \$21.2 million of which \$0.5 million represented a reimbursement of certain costs and we recorded this amount as a reduction of cost of sales.

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*Commissions, Management Fees and Other.* Commissions, management fees and other revenues increased in the 2007 periods compared to the 2006 periods primarily because of the increase in sales activity and related commissions received by our wholly owned subsidiary, Avalon Realty.

*Cost of Sales.* Cost of sales for the first six months of 2007 included reductions totaling \$1.7 million for Barton Creek Municipal Utility District (MUD) reimbursements. Cost of sales for the 2007 periods also decreased compared to the 2006 periods primarily because of a decrease in developed property sales in the 2007 periods.

**Commercial Leasing**

Our commercial leasing operating results primarily reflect the activities at Escarpment Village. In the second quarter of 2007, we committed to a plan to sell the office buildings at 7500 Rialto Boulevard. The results for 7500 Rialto Boulevard are classified as discontinued operations for the 2007 and 2006 periods and the results for 7000 West which was sold in March 2006 are classified as discontinued operations for the 2006 periods (see below). Summary commercial leasing operating results follow (in thousands):

	Second Quarter		Six Months	
	2007	2006	2007	2006
Rental income	\$ 885	\$ 522	\$ 1,812	\$ 569
Rental property costs	(856)	(299)	(1,519)	(425)
Depreciation	(285)	(217)	(553)	(223)
General and administrative expenses	(259)	(189)	(539)	(319)
Operating loss	\$ (515)	\$ (183)	\$ (799)	\$ (398)

In January 2006, we began earning rental income (less than \$0.1 million for the first quarter of 2006) from Escarpment Village. The grand opening of the Escarpment Village shopping center occurred on May 12, 2006. Rental income for Escarpment totaled \$0.9 million in the second quarter of 2007 and \$1.8 million in the first six months of 2007, and \$0.5 million in each of the 2006 periods.

**Other Financial Results**

General and administrative expenses increased to \$3.8 million in the first six months of 2007 from \$3.6 million in the first six months of 2006, primarily because of higher compensation costs.

**Non-Operating Results**

Interest income totaled \$0.6 million in the first six months of 2007, compared with \$0.2 million in the first six months of 2006, primarily reflecting interest on MUD reimbursements totaling approximately \$0.5 million in the first quarter of 2007.

**DISCONTINUED OPERATIONS**

In the second quarter of 2007, we committed to a plan to sell the office buildings at 7500 Rialto Boulevard and we have reported its assets, liabilities and operations as discontinued operations

In September 2006, we completed a second 75,000-square-foot office building at 7500 Rialto Boulevard in response to increased demand for office space within Lantana. As of June 30, 2007, we had leased approximately 50 percent of the space at the second office building and approximately 96 percent of the original office building. We earned rental income of \$0.7 million in the second quarter of 2007, \$0.4 million in the second quarter of 2006, \$1.3 million in the first six months of 2007 and \$0.7 million in the first six months of 2006.

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On March 27, 2006, our wholly owned subsidiary, Stratus 7000 West Joint Venture (7000 West JV), sold its two 70,000-square-foot office buildings at 7000 West William Cannon Drive (7000 West), known as the Lantana Corporate Center, to CarrAmerica Lantana, LP (CarrAmerica) for \$22.3 million, resulting in a gain of \$9.8 million (\$7.3 million net of taxes or \$1.01 per basic share and \$0.96 per diluted share) in the first six months of 2006. CarrAmerica paid us \$10.6 million cash at closing and assumed the \$11.7 million principal balance remaining under our 7000 West project loan.

Upon completion of the sale of 7000 West, Stratus ceased all involvement with the 7000 West office buildings. The operations, assets and liabilities of 7000 West represented a component of our commercial leasing segment.

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We earned rental income of \$1.1 million in the first six months of 2006 from the two fully leased office buildings at 7000 West.

Our discontinued operations generated net income (losses) of less than \$0.1 million in the second quarter of 2007, \$(0.6) million in the second quarter of 2006, \$10,000 in the first six months of 2007 and \$7.5 million, including a \$7.3 million gain net of taxes on the 7000 West sale, in the first six months of 2006.

## **CAPITAL RESOURCES AND LIQUIDITY**

### **Comparison of Six-Months 2007 and 2006 Cash Flows**

Operating activities provided cash of \$5.3 million during the first six months of 2007 and \$36.9 million during the first six months of 2006, including cash used in discontinued operations totaling \$0.3 million during the 2007 period and cash provided by discontinued operations totaling \$1.9 million during the 2006 period. Compared to the 2006 period, operating cash flows in the first six months of 2007 were reduced primarily because of the decrease in sales activities.

Cash used in investing activities totaled \$14.9 million during the first six months of 2007 and cash used in investing activities totaled \$13.2 million during the first six months of 2006. We received Barton Creek municipal utility district reimbursements totaling \$2.6 million in the first six months of 2007 and \$1.3 million in the first six months of 2006. The 2006 six-month period included \$10.0 million received from the sale of 7000 West (see “Discontinued Operations”) partly offset by \$6.0 million of capital expenditures on the second building that was under construction at 7500 Rialto Boulevard. Other real estate expenditures for the six-month periods of 2007 and 2006 included development costs for properties in the Barton Creek and Circle C communities (see “Development and Other Activities”).

Financing activities provided cash of \$12.3 million during the first six months of 2007, compared to \$15.0 million of cash used in financing activities during the first six months of 2006. Our financing activities in the first six months of 2007 include \$15.0 million of borrowings under our three new unsecured term loans, \$3.0 million of net repayments on our revolving line of credit and \$0.2 million of mortgage payments on our TIAA loan. In the first quarter of 2007, we also used \$0.2 million to repurchase shares of our common stock on the open market (see below). During the first six months of 2006, our financing activities included \$13.0 million of net repayments on our revolving line of credit, \$22.8 million of borrowings under our TIAA loan and \$18.2 million of net repayments on our project construction loans. See “Credit Facility and Other Financing Arrangements” below for a discussion of our outstanding debt at June 30, 2007.

In 2001, our Board of Directors approved an open market share purchase program for up to 0.7 million shares of our common stock. During the first quarter of 2007, we purchased 4,400 shares for \$0.2 million, a \$34.85 per share average. A total of 465,410 shares remain available under this program. Our loan agreement with Comerica provides a limit of \$6.5 million for common stock purchases after September 30, 2005 of which \$5.7 million is available at June 30, 2007. The timing of future purchases of our common stock is dependent on many factors including the price of our common shares, our cash flows and financial position, and general economic and market conditions.

### **Credit Facility and Other Financing Arrangements**

At June 30, 2007, we had total debt of \$62.5 million, including \$0.3 million of current debt, compared to total debt of \$50.7 million, including \$0.3 million of current debt, at December 31, 2006. Our debt outstanding at June 30, 2007 consisted of the following:

- \$40.0 million of borrowings outstanding under seven unsecured term loans, including two \$5.0 million loans, two \$8.0 million loans, a \$7.0 million loan and two \$3.5 million loans, all of which will mature in December 2011.

- \$22.5 million related to the mortgage from TIAA associated with the Escarpment Village shopping center, which matures in July 2016.

On June 1, 2007, we entered into three separate loan agreements with First American Asset Management (FAAM). Pursuant to the loan agreements, additional borrowings totaled \$15.0 million, \$10.6 million of which was used to pay down the outstanding amounts under our revolving credit facility with Comerica Bank, and the remainder will be used for operations, capital expenditures and other development costs, including the Block 21 Project. The loan agreements will mature in December 2011.

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The loan agreements contain customary financial covenants and other restrictions. Except in certain events related to a change in control, the loans may not be prepaid prior to December 31, 2007. Beginning on January 1, 2008, the loans may be prepaid subject to certain reinvestment charges as further described in the related promissory notes. The annual interest rate under the loan agreements is 6.915 percent. Repayments under the loan agreements can be accelerated upon the occurrence of certain customary events of default. Our obligations under the loan agreements are unsecured.

For a further discussion of our debt see Note 4 of our 2006 Form 10-K.

**STOCK BASED COMPENSATION**

Effective January 1, 2006, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" or (SFAS No. 123R), using the modified prospective transition method. For more information regarding our accounting for stock-based awards see Note 1 of our 2006 Form 10-K.

Compensation cost charged against earnings for stock-based awards is shown below (in thousands). We capitalized less than \$0.1 million of stock-based compensation costs to fixed assets in the second quarter of 2007 and \$0.1 million in the second quarter of 2006, \$0.1 million in the 2007 six-month period and \$0.2 million in the 2006 six-month period.

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
Cost of sales	\$ 89	\$ 62	\$ 292	\$ 195
General and administrative expenses	143	169	467	484
Total stock-based compensation cost	\$ 232	\$ 231	\$ 759	\$ 679

**CAUTIONARY STATEMENT**

Management's Discussion and Analysis of Financial Condition and Results of Operation and Disclosures about Market Risks contains forward-looking statements regarding future reimbursements for infrastructure costs, future events related to financing and regulatory matters, the expected results of our business strategy, and other plans and objectives of management for future operations and activities. Important factors that could cause actual results to differ materially from our expectations include economic and business conditions, business opportunities that may be presented to and pursued by us, changes in laws or regulations and other factors, many of which are beyond our control, and other factors that are described in more detail under "Risk Factors" located in our 2006 Form 10-K.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk.**

There have been no significant changes in our market risks since the year ended December 31, 2006. For more information, please read the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2006.

**Item 4. Controls and Procedures.**

(a) Evaluation of disclosure controls and procedures. Our chief executive officer and chief financial officer, with the participation of management, have evaluated the effectiveness of our "disclosure controls and procedures" (as defined in Rules 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1934) as of the end of the period covered by this quarterly report on Form 10-Q. Based on their evaluation, they have concluded that our disclosure

controls and procedures are effective in timely alerting them to material information relating to Stratus (including our consolidated subsidiaries) required to be disclosed in our periodic Securities and Exchange Commission filings.

(b) Changes in internal controls. There has been no change in our internal control over financial reporting that occurred during the second quarter that has materially affected, or is reasonably likely to materially affect our internal control over financial reporting.

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**PART II. – OTHER INFORMATION**

Item 1. Legal Proceedings.

We may from time to time be involved in various legal proceedings of a character normally incident to the ordinary course of our business. We believe that potential liability from any of these pending or threatened proceedings will not have a material adverse effect on our financial condition or results of operations. We maintain liability insurance to cover some, but not all, potential liabilities normally incident to the ordinary course of our business as well as other insurance coverage customary in our business, with such coverage limits as management deems prudent.

Item 1A. Risk Factors.

There have been no material changes to our risk factors since the year ended December 31, 2006. For more information, please read Item 1A included in our Form 10-K for the year ended December 31, 2006.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

In February 2001, our Board of Directors approved an open market share purchase program for up to 0.7 million shares of our common stock. The program does not have an expiration date. Our loan agreement with Comerica provides a limit of \$6.5 million for common stock purchases after September 30, 2005. At June 30, 2007, \$5.7 million remains under the Comerica agreement for purchases of common stock.

Item 6. Exhibits.

The exhibits to this report are listed in the Exhibit Index beginning on page E-1 hereof. Instruments with respect to other long-term debt of Stratus and its consolidated subsidiaries are omitted pursuant to Item 601(b)(4)(iii) of Regulation S-K since the total amount authorized under each such omitted instrument does not exceed 10 percent of the total assets of Stratus and its subsidiaries on a consolidated basis. Stratus hereby agrees to furnish a copy of any such instrument to the Securities and Exchange Commission upon request.

**SIGNATURE**

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

STRATUS PROPERTIES INC.

By: /s/ John E. Baker  
John E. Baker  
Senior Vice President and  
Chief Financial Officer  
(authorized signatory and  
Principal Financial Officer)

Date: August 8, 2007

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**STRATUS PROPERTIES INC.  
EXHIBIT INDEX**

Exhibit  
Number

- 3.1 Amended and Restated Certificate of Incorporation of Stratus. Incorporated by reference to Exhibit 3.1 to the Quarterly Report on Form 10-Q of Stratus for the quarter ended March 31, 2004 (Stratus' 2004 First Quarter Form 10-Q).
- 3.2 Certificate of Amendment to the Amended and Restated Certificate of Incorporation of Stratus, dated May 14, 1998. Incorporated by reference to Exhibit 3.2 to Stratus' 2004 First Quarter Form 10-Q.
- 3.3 Certificate of Amendment to the Amended and Restated Certificate of Incorporation of Stratus, dated May 25, 2001. Incorporated by reference to Exhibit 3.2 to the Annual Report on Form 10-K of Stratus for the year ended December 31, 2001 (Stratus' 2001 Form 10-K).
- 3.4 By-laws of Stratus, as amended as of February 11, 1999. Incorporated by reference to Exhibit 3.4 to Stratus' 2004 First Quarter Form 10-Q.
- 4.1 Rights Agreement dated as of May 16, 2002, between Stratus and Mellon Investor Services LLP, as Rights Agent, which includes the Certificates of Designation of Series C Participating Preferred Stock; the Forms of Rights Certificate Assignment, and Election to Purchase; and the Summary of Rights to Purchase Preferred Shares. Incorporated by reference to Exhibit 4.1 to Stratus' Registration Statement on Form 8-A dated May 22, 2002.
- 4.2 Amendment No. 1 to Rights Agreement between Stratus Properties Inc. and Mellon Investor Services LLC, as Rights Agent, dated as of November 7, 2003. Incorporated by reference to Exhibit 4.1 to the Current Report on Form 8-K of Stratus dated November 7, 2003.
- 10.1 Modification and Extension Agreement by and between Stratus Properties Inc., Stratus Properties Operating Co., L.P., Circle C Land, L.P., Austin 290 Properties, Inc., Calera Court, L.P., and Comerica Bank effective July 19, 2006. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K of Stratus dated July 19, 2006.
- 10.2 Loan Agreement by and between Stratus Properties Inc., Stratus Properties Operating Co., L.P., Circle C Land, L.P., Austin 290 Properties, Inc., Calera Court, L.P., and Comerica Bank dated as of September 30, 2005. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K of Stratus dated September 30, 2005.
- 10.3 Revolving Promissory Note by and between Stratus Properties Inc., Stratus Properties Operating Co., L.P., Circle C Land, L.P., Austin 290 Properties, Inc., Calera Court, L.P., and Comerica Bank dated as of September 30, 2005. Incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K of Stratus dated September 30, 2005.
- 10.4 Loan Agreement dated December 28, 2000, by and between Stratus Properties Inc. and Holliday Fenoglio Fowler, L.P., subsequently assigned to an affiliate of First American



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Asset Management. Incorporated by reference to Exhibit 10.20 to the Annual Report on Form 10-K of Stratus for the year ended December 31, 2000.

- 10.5 Loan Agreement dated June 14, 2001, by and between Stratus Properties Inc. and Holliday Fenoglio Fowler, L.P., subsequently assigned to an affiliate of First American Asset Management. Incorporated by reference to Exhibit 10.20 to the Quarterly Report on Form 10-Q of Stratus for the quarter ended September 30, 2001.
- 10.6 Construction Loan Agreement dated June 11, 2001, between 7500 Rialto Boulevard, L.P. and Comerica Bank-Texas. Incorporated by Reference to Exhibit 10.26 to Stratus' 2001 Form 10-K.
- 10.7 Modification Agreement dated January 31, 2003, by and between Lantana Office Properties I, L.P., formerly 7500 Rialto Boulevard, L.P., and Comerica Bank-Texas. Incorporated by reference to Exhibit 10.19 to the Quarterly Report on Form 10-Q of Stratus for the quarter ended March 31, 2003.

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- 10.8 Second Modification Agreement dated as of December 29, 2003, to be effective as of January 31, 2004, by and between Lantana Office Properties I, L.P., a Texas limited partnership (formerly known as 7500 Rialto Boulevard, L.P.), as borrower, and Comerica Bank, as lender. Incorporated by reference to Exhibit 10.20 to the Annual Report on Form 10-K of Stratus for the year ended December 31, 2003 (Stratus' 2003 Form 10-K).
- 10.9 Guaranty Agreement dated June 11, 2001, by Stratus Properties Inc. in favor of Comerica Bank-Texas. Incorporated by Reference to Exhibit 10.27 to Stratus' 2001 Form 10-K.
- 10.10 Loan Agreement dated September 22, 2003, by and between Calera Court, L.P., as borrower, and Comerica Bank, as lender. Incorporated by reference to Exhibit 10.26 to the Quarterly Report on Form 10-Q of Stratus for the quarter ended September 30, 2003.
- 10.11 Development Agreement dated August 15, 2002, between Circle C Land Corp. and City of Austin. Incorporated by reference to Exhibit 10.18 to the Quarterly Report on Form 10-Q of Stratus for the quarter ended September 30, 2002.
- 10.12 First Modification Agreement dated March 27, 2006, by and between Stratus 7000 West Joint Venture, as Old Borrower, and CarrAmerica Lantana, LP, as New Borrower, and Teachers Insurance and Annuity Association of America, as Lender. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K of Stratus dated March 27, 2006.
- 10.13 Agreement of Sale and Purchase dated November 23, 2005, by and between Stratus Properties Operating Co., L.P., as Seller, and Advanced Micro Devices, Inc., as Purchaser. Incorporated by reference to Exhibit 10.12 to the Quarterly Report on Form 10-Q of Stratus for the quarter ended March 31, 2006 (Stratus' 2006 First Quarter Form 10-Q).
- 10.14 First Amendment to Agreement of Sale and Purchase dated April 26, 2006, by and between Stratus Properties Operating Co., L.P., as Seller, and Advanced Micro Devices, Inc., as Purchaser. Incorporated by reference to Exhibit 10.13 to Stratus' 2006 First Quarter Form 10-Q.
- 10.15 Deed of Trust, Assignment of Leases and Rents, Security Agreement and Fixture Filing dated as of June 30, 2006, by and among Escarpment Village, L.P. and Teachers Insurance and Annuity Association of America. Incorporated by reference to Exhibit 10.15 to the Quarterly Report on Form 10-Q of Stratus for the quarter ended June 30, 2006 (Stratus' 2006 Second Quarter Form 10-Q).
- 10.16 Promissory Note dated as of June 30, 2006, by and between Escarpment Village, L.P. and Teachers Insurance and Annuity Association of America. Incorporated by reference to Exhibit 10.16 to Stratus' 2006 Second Quarter Form 10-Q.
- 10.17 Amended and Restated Loan Agreement between Stratus Properties Inc. and American Strategic Income Portfolio Inc.-II dated as of December 12, 2006. Incorporated by reference to Exhibit 10.17 to the Annual Report on Form 10-K of Stratus for the year ended December 31, 2006 (Stratus' 2006 Form 10-K).
- 10.18

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Amended and Restated Loan Agreement between Stratus Properties Inc. and American Select Portfolio Inc. dated as of December 12, 2006. Incorporated by reference to Exhibit 10.18 to Stratus' 2006 Form 10-K.

10.19 Loan Agreement between Stratus Properties Inc. and Holliday Fenoglio Fowler, L.P. dated as of December 12, 2006. Incorporated by reference to Exhibit 10.19 to Stratus' 2006 Form 10-K.

10.20 Loan Agreement between Stratus Properties Inc. and Holliday Fenoglio Fowler, L.P. dated as of December 12, 2006. Incorporated by reference to Exhibit 10.20 to Stratus' 2006 Form 10-K.

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- 10.21 Letter Agreement between Stratus Properties Inc. and Canyon-Johnson Urban Fund II, L.P., dated as of May 4, 2007.
- 10.22 Loan Agreement between Stratus Properties Inc. and Holliday Fenoglio Fowler, L.P. dated as of June 1, 2007, subsequently assigned to American Select Portfolio Inc., an affiliate of First American Asset Management.
- 10.23 Loan Agreement between Stratus Properties Inc. and Holliday Fenoglio Fowler, L.P. dated as of June 1, 2007, subsequently assigned to American Strategic Income Portfolio Inc., an affiliate of First American Asset Management.
- 10.24 Loan Agreement between Stratus Properties Inc. and Holliday Fenoglio Fowler, L.P. dated as of June 1, 2007, subsequently assigned to American Strategic Income Portfolio Inc.-III, an affiliate of First American Asset Management.

Executive Compensation Plans and Arrangements (Exhibits 10.25 through 10.36)

- 10.25 Stratus' Performance Incentive Awards Program, as amended, effective February 11, 1999. Incorporated by reference to Exhibit 10.24 to Stratus' 2004 First Quarter Form 10-Q.
- 10.26 Stratus Properties Inc. Stock Option Plan, as amended and restated. Incorporated by reference to Exhibit 10.22 to the Quarterly Report on Form 10-Q of Stratus for the quarter ended March 31, 2007 (Stratus' 2007 First Quarter Form 10-Q).
- 10.27 Stratus Properties Inc. 1996 Stock Option Plan for Non-Employee Directors, as amended and restated. Incorporated by reference to Exhibit 10.23 to Stratus' 2007 First Quarter Form 10-Q.
- 10.28 Stratus Properties Inc. 1998 Stock Option Plan, as amended and restated. Incorporated by reference to Exhibit 10.24 to Stratus' 2007 First Quarter Form 10-Q.
- 10.29 Form of Notice of Grant of Nonqualified Stock Options under the 1998 Stock Option Plan. Incorporated by reference to Exhibit 10.24 to the Quarterly Report on Form 10-Q of Stratus for the quarter ended June 30, 2005 (Stratus' 2005 Second Quarter Form 10-Q).
- 10.30 Form of Restricted Stock Unit Agreement under the 1998 Stock Option Plan. Incorporated by reference to Exhibit 10.26 to Stratus' 2007 First Quarter Form 10-Q.
- 10.31 Stratus Properties Inc. 2002 Stock Incentive Plan, as amended and restated. Incorporated by reference to Exhibit 10.27 to Stratus' 2007 First Quarter Form 10-Q.
- 10.32 Form of Notice of Grant of Nonqualified Stock Options under the 2002 Stock Incentive Plan. Incorporated by reference to Exhibit 10.27 to Stratus' 2005 Second Quarter Form 10-Q.
- 10.33 Form of Restricted Stock Unit Agreement under the 2002 Stock Incentive Plan. Incorporated by reference to Exhibit 10.29 to Stratus' 2007 First Quarter Form 10-Q.

- 10.34 Stratus Director Compensation. Incorporated by reference to Exhibit 10.20 to the Annual Report on Form 10-K of Stratus for the year ended December 31, 2005.
- 10.35 Change of Control Agreement between Stratus Properties Inc. and William H. Armstrong III, effective as of January 26, 2007. Incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K of Stratus dated January 24, 2007.
- 10.36 Change of Control Agreement between Stratus Properties Inc. and John E. Baker, effective as of January 26, 2007. Incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K of Stratus dated January 24, 2007.
- 15.1 Letter from PricewaterhouseCoopers LLP regarding the unaudited interim financial statements.

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31.1 Certification of Principal Executive Officer pursuant to Rule 13a-14(a)/15d-14(a).

31.2 Certification of Principal Financial Officer pursuant to Rule 13a-14(a)/15d-14(a).

32.1 Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350.

32.2 Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350.

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