STRATUS PROPERTIES INC
Form 10-K
March 17, 2008

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

FORM 10-K

(Mark One)
[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 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 (IRS 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)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, par value $0.01 per share	NASDAQ
Preferred Stock Purchase Rights	NASDAQ

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act 0 Yes R No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. 0 Yes R No

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 0 No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. 0

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, non-accelerated filer or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one): 0 Large accelerated filer R Accelerated filer 0 Non-accelerated filer 0 Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). 0 Yes R No

The aggregate market value of common stock held by non-affiliates of the registrant was approximately $133.8 million on February 29, 2008, and approximately $152.4 million on June 30, 2007.

Common stock issued and outstanding was 7,566,181 shares on February 29, 2008, and 7,568,416 shares on June 30, 2007.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of our Proxy Statement for our 2008 Annual Meeting to be held on May 6, 2008, are incorporated by reference into Part III (Items 10, 11, 12, 13 and 14) of this report.

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PART I

Item 1. Business

Except as otherwise described herein or the context otherwise requires, all references to “Stratus,” “we,” “us,” and “our” in this Form 10-K refer to Stratus Properties Inc. and all entities owned or controlled by Stratus Properties Inc. All of our periodic report filings with the Securities and Exchange Commission (SEC) pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, are available, free of charge, through our website, www.stratusproperties.com, including our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and any amendments to those reports. These reports and amendments are available through our website as soon as reasonably practicable after we electronically file or furnish such material to the SEC. All subsequent references to “Notes” in this report refer to the Notes to Consolidated Financial Statements located in Item 8. of this Form 10-K.

Overview

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 December 31, 2007, our most significant holding is the 1,678 acres of residential, multi-family and commercial property and 25 developed residential estate lots located within the Barton Creek community. We also own approximately 350 acres of undeveloped commercial property and approximately 37 acres of commercial property under development within the Circle C Ranch (Circle C) community. Our other properties in the Circle C community include Meridian, which is an 800-lot residential development. At December 31, 2007, Meridian consisted of approximately 249 acres under development and 58 developed residential lots. Our remaining Austin holdings at December 31, 2007, consisted of 223 acres of commercial property and two 75,000-square-foot office buildings, one of which is 90 percent leased and the other of which is approximately 94 percent leased, at 7500 Rialto Boulevard located within Lantana.

In January 2004, we acquired approximately 68 acres of land in Plano, Texas, which we refer to as Deerfield. At December 31, 2007, our Deerfield property consisted of the final 21 developed residential lots, which were sold in January 2008. We also own two acres of undeveloped commercial property in San Antonio, Texas.

In November 2005, we formed a joint venture partnership 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 completed brown field remediation and permitting of the property and are now proceeding with infrastructure development.

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 hotel, residential, retail, office and entertainment uses on approximately two acres. We have executed agreements with Starwood Hotels & Resorts Worldwide, Inc. for the development of a W Hotel and Residences on the site. On May 8, 2007, we announced our 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 of Austin (the City) and the grand opening for the onsite sales center was held in conjunction with the groundbreaking ceremony in October 2007.

In 2006, we sold for $22.3 million our two 70,000-square-foot office buildings at 7000 West William Cannon Drive (7000 West), known as the Lantana Corporate Center. On October 12, 2007, we sold Escarpment Village, which is a 168,000 square-foot retail center anchored by a grocery store in the Circle C community, for $46.5 million, before closing costs and other adjustments. Accordingly, we have reported 7000 West's and Escarpment Village's assets, liabilities and results of operations as discontinued operations (see "Discontinued Operations" and Note 7).

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Company Strategies and Development Activities

From our formation in 1992 through 2000, our primary objectives were to reduce our indebtedness and increase our financial flexibility. In pursuing these objectives, we reduced our debt to $8.4 million at December 31, 2000 from $493.3 million in March 1992. As a result of the settlement of certain development-related lawsuits and an increasing level of cooperation with the City regarding the development of our properties, we substantially increased our development activities and expenditures during the last five years (see discussion below), which has resulted in our debt increasing to $61.5 million at December 31, 2007. We also had cash and cash equivalents of $40.9 million at December 31, 2007. We have funded our development activities primarily through sales proceeds, $40.0 million of unsecured term loans and our expanded credit facility (see “Credit Facility and Other Financing Arrangements” below and Note 4), which was established as a result of the positive financing relationship we have built with Comerica Bank (Comerica) over the past several years. In August 2002, the City granted final approval of a development agreement (Circle C settlement) and permanent zoning for our real estate located within the Circle C community, thereby establishing all essential municipal development regulations applicable to our Circle C properties for 30 years (see “Development and Other Activities” within Items 7. and 7A. and Note 8). The credit facility and other sources of financing have increased our financial flexibility and, together with the Circle C settlement, have allowed us to focus our efforts on developing our properties, acquiring other properties and increasing shareholder value.

Our overall strategy is to enhance the value of our properties by securing and maintaining development entitlements and developing and building real estate projects on these properties for sale or investment. We also continue to investigate and pursue opportunities for new projects that offer the possibility of acceptable returns and risk. Our progress towards accomplishing these goals includes the following:

- Over the past several years we have successfully permitted and developed significant projects in our Barton Creek and Lantana project areas.

Barton Creek

Wimberly Lane. During 1999, we completed the development of the 75 residential lots at the Wimberly Lane subdivision at Barton Creek, all of which were sold by the end of 2003. During 2004, we completed the development of the 47 lots in the second phase of Wimberly Lane (Wimberly Lane Phase II), and we also entered into a contract with a national homebuilder to sell 41 of these Wimberly Lane Phase II lots. The lots are being sold on a scheduled take down basis. As of December 31, 2007, the final two remaining lots are on schedule for sale in the first half of 2008.

Mirador and Escala Drive. We completed construction of Mirador, a subdivision within the Barton Creek community adjoining the Escala Drive subdivision in late-2001. We developed 34 estate lots in the Mirador subdivision, with each lot averaging approximately 3.5 acres in size, and have sold 32 of these lots. As of December 31, 2007, we owned two Mirador estate lots. By the end of 2006, we had sold all of the 54 lots at Escala Drive in the Barton Creek community.

Calera. In 2002, we secured subdivision plat approval for a new residential subdivision called Calera, which consists of 155 lots. During 2004, we began construction of courtyard homes at Calera Court, the initial phase of the Calera subdivision, which will include 16 homesites on 16 acres. The second phase of Calera, Calera Drive, consisting of 53 single-family lots, many of which adjoin 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 December 31, 2007, only eight 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 was completed in early 2008.

Barton Creek Village. In the second quarter of 2007, we completed the first phase of Barton Creek Village, which includes a 22,000-square-foot retail building. In July 2007, we began construction of a 3,300-square-foot bank building within this retail complex, and it was completed in early 2008. Construction of the second retail building will begin by the second half of 2008.

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Lantana

In 2000, we received final subdivision plat approval from the City to develop approximately 170 acres of commercial and multi-family real estate within Lantana. We completed and leased the two 70,000-square-foot office buildings at 7000 West by the third quarter of 2000. During 2001, we reached agreement with the City concerning development of a 417-acre portion of the Lantana community. The agreement reflected a cooperative effort between the City and us to allow development based on grandfathered entitlements, while adhering to stringent water quality standards and other enhancements to protect the environment. With this agreement, we completed the core entitlement process for the entire Lantana project. The required infrastructure development at the site known as Rialto Boulevard was completed during 2001. During 2002, we completed the first 75,000-square-foot office building at 7500 Rialto Boulevard.

In 2006, we sold 7000 West for $22.3 million (see “Discontinued Operations” and Note 7) and a 58-acre tract at Lantana to Advanced Micro Devices, Inc. (NYSE: AMD) for $21.2 million. As demand for office space within Lantana increased, we constructed a second 75,000-square-foot office building at 7500 Rialto Boulevard, which was completed in September 2006. As of December 31, 2007, we had leased 90 percent of the first Rialto Boulevard office building and approximately 94 percent of the second office building.

Lantana is a partially developed, mixed-use project with our remaining entitlements for approximately 1.0 million square feet of office and retail use on 223 acres as of December 31, 2007. Regional utility and road infrastructure is in place with capacity to serve Lantana at full build-out permitted under our existing entitlements.

- We have made significant progress in obtaining the permitting necessary to pursue development of additional Austin-area property.

Circle C Community

In August 2002, the City granted final approval of the Circle C settlement and permanent zoning for our real estate located within the Circle C community. Those approvals permitted development of approximately 1.0 million square feet of commercial space and 1,730 residential units, including 900 multi-family units and 830 single-family residential lots. In 2004, we amended our Circle C settlement with the City to increase the amount of permitted commercial space from 1.0 million square feet to 1.16 million square feet in exchange for a decrease in allowable multi-family units from 900 units to 504 units. The Circle C settlement, effective August 2002, firmly established all essential municipal development regulations applicable to our Circle C properties for 30 years. The City also provided us $15 million of cash incentives in connection with our future development of our Circle C and other Austin-area properties. These incentives, which are in the form of Credit Bank capacity, can be used for City fees and reimbursement for certain infrastructure costs. Annually, we may elect to sell up to $1.5 million of the incentives to other developers for their use in paying City fees related to their projects. As of December 31, 2007, we have permanently used $6.5 million of our City-based incentives including cumulative sales of $3.5 million to other developers, and we also have $3.1 million in Credit Bank capacity in use as temporary fiscal deposits. At December 31, 2007, unencumbered Credit Bank capacity was $5.4 million.

We have commenced development activities at the Circle C community based on the entitlements secured in our Circle C settlement with the City, as amended in 2004. The preliminary plan has been approved for Meridian, an 800-lot residential development at the Circle C community. In October 2004, we received final City plat and construction permit approvals for the first phase of Meridian, and construction commenced in January 2005. 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 was substantially completed in March 2006. Development of the 108-lot third phase of

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Meridian was completed in September 2007. The 118-lot fourth phase will commence in 2008 and completion is expected by the end of 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 early 2008. Development of the final phase of Meridian, which consists of 57 one-acre lots, is expected to commence by the end of 2008.

In addition, several retail sites at the Circle C community received final City approvals and are being developed. Escarpment Village, a 168,000-square-foot retail project anchored by a grocery store, opened in May 2006. On October 12, 2007, we sold Escarpment Village for $46.5 million, before closing costs and other adjustments (see "Discontinued Operations" and Note 7).

- We believe that we have the right to receive approximately $19.1 million of future reimbursements associated with previously incurred Barton Creek utility infrastructure development costs.

At December 31, 2007, we had approximately $9.5 million of expected future reimbursements of previously incurred costs recorded as a component of "Real estate, commercial leasing assets and facilities, net" on our balance sheet. The remaining future reimbursements are not recorded on our balance sheet because they relate to properties previously sold or represent a component of the $115 million impairment charge we recorded in 1994. Additionally, a significant portion of the substantial additional costs, which we will incur in the future as our development activities at Barton Creek continue, will be eligible for reimbursement. We received total infrastructure reimbursements, comprised of Barton Creek Municipal Utility District (MUD) reimbursements, of $4.8 million during 2007, $1.6 million during 2006 and $4.9 million during 2005.

- We completed the development and related sale of lots for a project in Plano, Texas.

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 non-refundable option payment was applied against subsequent purchases of lots by the homebuilder after certain thresholds were achieved and was recognized by us as income as lots were sold. 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. In January 2008, we sold the remaining lots.

- We formed a joint venture in November 2005 to purchase and develop a multi-use property in Austin, Texas.

Crestview Station

Our joint venture with Trammell Crow acquired an approximate 74-acre tract at the intersection of Airport Boulevard and Lamar Boulevard for $7.7 million. The property, known as Crestview Station, is a single-family, multi-family, retail and office development, which is located on the commuter rail line approved by City of Austin voters. With Trammel Crow, we have completed brown field environmental remediation and permitting of the property and are now proceeding with infrastructure development. In September 2007, the State of Texas certified that the remediation was complete.

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- In December 2006, we purchased land in downtown Austin, Texas, representing a city block, to develop as a multi-use property.

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, known as Block 21, includes an entire city block and is planned for a mixture of hotel, residential, retail, office 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. On May 8, 2007, we announced our 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 the grand opening for the onsite sales center was held in conjunction with the groundbreaking ceremony in October 2007.

Strategic Alternatives for Enhancing Shareholder Value. 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.

Credit Facility and Other Financing Arrangements

Credit Facility. We established a banking relationship with Comerica in 1999 that has substantially enhanced our financial flexibility. In 2005, we replaced our $30.0 million credit facility with a $45.0 million Comerica revolving credit facility, which sets limitations on liens and transactions with affiliates and requires that certain financial ratios be maintained. The facility allows us to purchase up to $6.5 million of our outstanding common stock after September 30, 2005, of which $4.4 million remains available at December 31, 2007. In May 2006, we entered into a modification and extension agreement to extend the maturity and decrease the interest rate on the Comerica revolving credit facility. In May 2007, we entered into another modification and extension agreement to extend the maturity and further decrease the interest rate on the revolving credit facility. The $45.0 million facility, of which $3.0 million is provided for our Calera Court project, matures on May 30, 2009. Interest on the facility now accrues, at our option, at Comerica’s rate minus 1.10 percent or London Interbank Offered Rate (LIBOR) plus 1.65 percent, subject to a minimum annual rate of 5.0 percent. Security for obligations outstanding under the facility includes our properties within the Barton Creek community and certain of our properties within Lantana and the Circle C community. At December 31, 2007, no amounts were outstanding under the revolving credit facility.

Unsecured Term Loans. We have $40.0 million of borrowings outstanding under seven unsecured term loans with First American Asset Management (FAAM), 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.

In December 2006, we amended our two unsecured $5.0 million term loans with FAAM. The amended agreements extend the maturities of both loans and decrease the annual interest rates on both loans to 6.56 percent.

In December 2006, we also entered into two separate new loan agreements with FAAM to borrow an additional $15.0 million to purchase the land being used in connection with our Block 21 project. Amounts borrowed under both loans bear interest at an annual rate of 6.56 percent.

In June 2007, we entered into three separate loan agreements with 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, and the remainder was used for operations, capital expenditures and other

development costs, including Block 21.

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The loan agreements contain customary financial covenants and other restrictions. 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.

Lantana Promissory Note. On December 14, 2007, our wholly owned subsidiary, Lantana Office Properties I, L.P., ("Lantana"), signed a promissory note to The Lincoln National Life Insurance Company. Under the terms of the note, Lantana borrowed $21.5 million, which will be used for development costs and general corporate purposes. The note matures on January 1, 2018. The note contains customary financial covenants and other restrictions and bears interest at a rate of 5.99 percent per year.

Prepayment of the note is prohibited prior to February 1, 2010. Prepayment of the note in whole, subsequent to February 1, 2010, is subject to a prepayment premium of the greater of (1) one percent of the outstanding principal balance of the note on the prepayment date or (2) the result of the sum of the present values of the remaining payments due from the prepayment date through the maturity date minus the outstanding principal balance of the note as of the prepayment date. Prepayment of the note in part is prohibited. Repayments under the note can be accelerated by the lender upon the occurrence of certain customary events of default. Lantana's obligations under the note are secured by a first lien on real property and improvements and an assignment of rents and present and future leases related to the office buildings at 7500 Rialto Boulevard.

Discontinued Operations

Escarpment Village. On October 12, 2007, we sold the Escarpment Village shopping center, located in Austin, Texas, to Lake Villa, L.L.C. (the Purchaser) for $46.5 million, before closing costs and other adjustments. The Purchaser paid $23.0 million in cash at closing and assumed the $22.4 million principal balance remaining under our loan from Teachers Insurance and Annuity Association of America (TIAA). We used a portion of the net proceeds from the sale to pay the outstanding balance on the $45.0 million Comerica revolving credit facility and will use the remainder of the net proceeds for general corporate purposes. We recorded a gain of $16.1 million ($11.0 million net of taxes or $1.46 per basic share and $1.43 per diluted share) on the sale in 2007.

Upon completion of the sale of Escarpment Village, we ceased all involvement with the Escarpment Village shopping center. The results of operations, assets and liabilities of Escarpment Village, which have been classified as discontinued operations in our consolidated financial statements, previously represented a component of our commercial leasing segment.

7000 West. In 2006, we sold 7000 West to CarrAmerica Lantana, LP (CarrAmerica) for $22.3 million, resulting in a gain of $9.8 million ($8.3 million net of taxes or $1.13 per basic share and $1.08 per diluted share). 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, we 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.

Regulation and Environmental Matters

Our real estate investments are subject to extensive local, city, county and state rules and regulations regarding permitting, zoning, subdivision, utilities and water quality as well as federal rules and regulations regarding air and water quality and protection of endangered species and their habitats. Such regulation has delayed and may continue to delay development of our properties and result in higher developmental and administrative costs. See "Risk Factors."

We have made, and will continue to make, expenditures for the protection of the environment with respect to our real estate development activities. Emphasis on environmental matters will result in additional costs in the future. Based

on an analysis of our operations in relation to current and presently anticipated environmental requirements, we currently do not anticipate that these costs will have a material adverse effect on our future operations or financial condition.

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Employees

At December 31, 2007, we had a total of 29 employees located at our Austin, Texas headquarters. Additionally, since January 1, 1996, numerous services necessary for our business and operations, including certain executive, administrative, accounting, financial, tax and other services, have been performed by FM Services Company (FM Services) pursuant to a services agreement. FM Services is a wholly owned subsidiary of Freeport-McMoRan Copper & Gold Inc. Either party may terminate the services agreement at any time upon 60 days notice or mutual written agreement.

Item 1A. Risk Factors

This report includes "forward looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements about our plans, strategies, expectations, assumptions and prospects. "Forward-looking statements" are all statements other than statements of historical fact, or current facts, that address activities, events, outcomes and other matters that we plan, expect, intend, assume, believe, budget, predict, forecast, project, estimate or anticipate (or other similar expressions) will, should or may occur in the future, such as: statements regarding our financial plans; our indebtedness; share repurchases; strategic plans; future financing plans; development and capital expenditures; business strategies; our ability to obtain necessary permits for new developments; and other plans and objectives for future operations and activities.

Forward-looking statements are based on our assumptions and analysis made in light of our experience and perception of historical trends, current conditions, expected future developments and other factors that we believe are appropriate under the circumstances. These statements are subject to a number of assumptions, risks and uncertainties, including the risk factors discussed below and in our other filings with the SEC, general economic and business conditions, the 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. Readers are cautioned that forward-looking statements are not guarantees of future performance, and the actual results or developments may differ materially from those projected, predicted or assumed in the forward-looking statements. Important factors that could cause actual results to differ materially from our expectations include, among others, the following:

We are vulnerable to concentration risks because our operations are currently almost exclusive to the Austin, Texas, market.

Our real estate activities are almost entirely located in Austin, Texas. Because of our geographic concentration and limited number of projects, our operations are more vulnerable to local economic downturns and adverse project-specific risks than those of larger, more diversified companies. The performance of the Austin economy greatly affects our sales and consequently the underlying values of our properties. The Austin economy is heavily influenced by conditions in the technology industry. In a weak technology market, which had been the condition between 2001 and 2004, we experienced reduced sales, primarily affecting our “high-end” properties. Although Austin real estate market conditions have improved since 2005, our geographic concentration may create increased vulnerability during regional economic downturns, which can significantly affect our financial condition and results of operations.

If we are unable to generate sufficient cash from operations, we may find it necessary to curtail our development activities.

Significant capital resources will be required to fund our development expenditures. Our performance continues to depend on future cash flows from real estate sales and rental income, and there can be no assurance that we will generate sufficient cash flow or otherwise obtain sufficient funds to meet the expected development plans for our properties.

Our results of operations and financial condition are greatly affected by the performance of the real estate industry.

The real estate industry is highly cyclical and is affected by changes in national, global and local economic conditions and events, such as employment and income levels, availability of financing, interest rates, consumer confidence and overbuilding or decrease in demand. Our real estate activities are subject to

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numerous factors beyond our control, including local real estate market conditions (both where our properties are located and in areas where our potential customers reside), substantial existing and potential competition, general national, regional and local economic conditions, fluctuations in interest rates and mortgage availability, changes in demographic conditions and changes in government regulations or requirements. The occurrence of any of the foregoing could result in a reduction or cancellation of sales and/or lower gross margins for sales. Lower than expected sales as a result of these occurrences could have a material adverse effect on the level of our profits and the timing and amounts of our cash flows.

Real estate investments often cannot easily be converted into cash and market values may be adversely affected by these economic circumstances, market fundamentals, competition and demographic conditions. Because of the effect these factors have on real estate values, it is difficult to predict with certainty the level of future sales or sales prices that will be realized for individual assets.

Mortgage financing issues, including lack of supply of mortgage loans and tightened lending requirements, could reduce demand for our products.

Our real estate operations are dependent upon the availability and cost of mortgage financing for potential customers, to the extent they finance their purchases, and for buyers of the potential customers' existing residences. Many mortgage lenders and investors in mortgage loans are currently experiencing severe financial difficulties arising from losses incurred on sub-prime and other loans originated before the downturn in the real estate market. These factors have led to a decrease in the availability of financing and an increase in the cost of financing. These problems in the mortgage lending industry could adversely affect potential purchasers of our products, thus having a negative effect on demand for our products.

Our indebtedness could adversely affect our operating results and financial condition.

As of December 31, 2007, the outstanding principal amount of our indebtedness was $61.5 million. Our level of indebtedness could have important consequences. For example, it could:

- increase our vulnerability to adverse changes in economic and industry conditions;
- require us to dedicate a substantial portion of our cash flow from operations and proceeds from asset sales to pay or provide for our indebtedness, thus reducing the availability of cash flows to fund working capital, capital expenditures, acquisitions, investments and other general corporate purposes;
- limit our flexibility to plan for, or react to, changes in our business and the market in which we operate;
- place us at a competitive disadvantage to our competitors that have less debt; and
- limit our ability to borrow money to fund our working capital, capital expenditures, debt service requirements and other financing needs.

In addition, the terms of the agreements governing our indebtedness include restrictive covenants and require that certain financial ratios be maintained. We may also need to incur additional indebtedness in the future in the ordinary course of business to fund our development projects and our operations. If new debt is added to current debt levels, the risks described above could intensify. Further, if future debt financing is not available to us when required or is not available on acceptable terms, we may be unable to grow our business, take advantage of business opportunities, respond to competitive pressures or refinance maturing debt, any of which could have a material adverse effect on our operating results and financial condition. Our future performance is dependent on future cash flows from real estate

sales, and there can be no assurance that we will generate sufficient cash flow.

Unfavorable changes in market and economic conditions could hurt occupancy or rental rates.

Market and economic conditions may significantly affect rental rates. Occupancy and rental rates in our market, in turn, may significantly affect our profitability and our ability to satisfy our financial obligations. The risks that may affect conditions in our market include the following:

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- the economic climate, which may be adversely impacted by industry slowdowns and other factors;
- local conditions, such as oversupply of office space and the demand for office space;
- the inability or unwillingness of tenants to pay their current rent or rent increases; and
- competition from other available office buildings and changes in market rental rates.

We cannot predict with certainty whether any of these factors will occur or whether they will have an adverse affect on our operations.

Our operations are subject to an intensive regulatory approval process and opposition from environmental groups that could cause delays and increase the costs of our development efforts or preclude such developments entirely.

Before we can develop a property, we must obtain a variety of approvals from local and state governments with respect to such matters as zoning, density, parking, subdivision, site planning and environmental issues. Some of these approvals are discretionary by nature. Because government agencies and special interest groups have in the past expressed concerns about our development plans in or near Austin, our ability to develop these properties and realize future income from our properties could be delayed, reduced, prevented or made more expensive.

Several special interest groups have long opposed our plans in the Austin area and have taken various actions to partially or completely restrict development in some areas, including areas where some of our most valuable properties are located. We have actively opposed these actions and do not believe unfavorable rulings would have a significant long-term adverse effect on the overall value of our property holdings. However, because of the regulatory environment that has existed in the Austin area and the intensive opposition of several special interest groups, there can be no assurance that our expectations will prove correct.

Our operations are subject to governmental environmental regulation, which can change at any time and generally would result in an increase to our costs.

Real estate development is subject to state and federal regulations and to possible interruption or termination because of environmental considerations, including, without limitation, air and water quality and protection of endangered species and their habitats. Certain of the Barton Creek properties include nesting territories for the Golden Cheek Warbler, a federally listed endangered species. In 1995, we received a permit from the United States (U.S.) Wildlife Service pursuant to the Endangered Species Act, which to date has allowed the development of the Barton Creek and Lantana properties free of restrictions under the Endangered Species Act related to the maintenance of habitat for the Golden Cheek Warbler.

Additionally, in April 1997, the U.S. Department of Interior listed the Barton Springs Salamander as an endangered species after a federal court overturned a March 1997 decision by the Department of Interior not to list the Barton Springs Salamander based on a conservation agreement between the State of Texas and federal agencies. The listing of the Barton Springs Salamander has not affected, nor do we anticipate it will affect, our Barton Creek and Lantana properties for several reasons, including the results of technical studies and our U.S. Fish and Wildlife Service 10(a) permit obtained in 1995. The development permitted by our 2002 Circle C settlement with the City has been reviewed and approved by the U.S. Fish and Wildlife Service and, as a result, we do not anticipate that the 1997 listing of the Barton Springs Salamander will impact our Circle C properties.

We are making, and will continue to make, expenditures with respect to our real estate development for the protection of the environment. Emphasis on environmental matters will result in additional costs in the future. New

environmental regulations or changes in existing regulations or their enforcement may be enacted and such new regulations or changes may require significant expenditures by us. The recent trend toward stricter standards in environmental legislation and regulations is likely to continue and could have an additional impact on our operating costs.

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The real estate business is very competitive and many of our competitors are larger and financially stronger than we are.

The real estate business is highly competitive. We compete with a large number of companies and individuals that have significantly greater financial, sales, marketing and other resources than we have. Our competitors include local developers who are committed primarily to particular markets and also national developers who acquire properties throughout the U.S.

Our operations are subject to natural risks.

Our performance may be adversely affected by weather conditions that delay development or damage property.

Our common stock is thinly traded; therefore, our stock price may fluctuate more than the stock market as a whole.

As a result of the thin trading market for our stock, its market price may fluctuate significantly more than the stock market as a whole or the stock prices of similar companies. Without a larger float, our common stock will be less liquid than the stock of companies with broader public ownership, and as a result, the trading prices for our common stock may be more volatile. Among other things, trading of a relatively small volume of common stock may have a greater impact on the trading price than would be the case if public float were larger.

Item 1B. Unresolved Staff Comments
Not applicable.

Item 2. Properties
Our developed lots, developed or under development acreage and undeveloped acreage as of December 31, 2007, are provided in the following table. The undeveloped acreage shown in the table is presented according to anticipated uses for single-family lots, multi-family units and commercial development based upon our understanding of the properties' existing entitlements. However, there is no assurance that the undeveloped acreage will be so developed because of the nature of the approval and development process and market demand for a particular use. Undeveloped acreage includes raw real estate that can be sold "as is" i.e. no infrastructure or development work has begun on such property. A developed lot is an individual tract of land that has been developed and permitted for residential use. A developed lot may be sold with a home already built on it. As of December 31, 2007, we own only six lots with homes either built or being built on them (the Calera Court homes). Developed acreage or acreage under development includes real estate for which infrastructure work over the entire property has been completed, is currently being completed or is able to be completed and necessary permits have been received.

		Acreage									
		Developed or Under Development					Undeveloped				
	Developed Lots	Single Family	Multi-family	Commercial	Total	Single Family	Multi-family	Commercial	Total	Total Acreage
Austin										
Barton Creek	25	642	249	376	1,267	391	-	20	411	1,678
Lantana	-	-	-	223	223	-	-	-	-	223
Circle C	58	249	-	37	286	-	-	350	350	636
Block 21	-	-	-	2	2	-	-	-	-	2
Plano										
Deerfield	21	-	-	-	-	-	-	-	-	-

San Antonio										
Camino Real	-	-	-	-	-	-	-	2	2	2
Total	104	891	249	638	1,778	391	-	372	763	2,541

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The following schedule summarizes the estimated development potential of our Austin-area acreage as of December 31, 2007:

	Single Family (lots)	Multi-family (units)	Commercial Office (gross square feet)	Commercial Retail (gross square feet)
Barton Creek	367	1,860	1,590,000	35,000
Lantana	-	-	1,220,393	470,000
Circle C	491	-	787,500	372,500
Total	858	1,860	3,597,893	877,500

Item 3. 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 4. Submission of Matters to a Vote of Security Holders

Not applicable.

Executive Officers of the Registrant

Certain information, as of February 29, 2008, regarding our executive officers is set forth in the following table and accompanying text.

Name	Age	Position or Office
William H. Armstrong III	43	Chairman of the Board, President and Chief Executive Officer
John E. Baker	61	Senior Vice President and Chief Financial Officer
Kenneth N. Jones	48	General Counsel and Secretary

Mr. Armstrong has been employed by us since our inception in 1992. He has served as Chairman of the Board since August 1998, Chief Executive Officer since May 1998 and President since August 1996.

Mr. Baker has served as our Senior Vice President and Chief Financial Officer since August 2002. He previously served as Senior Vice President – Accounting from May 2001 until August 2002 and as our Vice President – Accounting from August 1996 until May 2001.

Mr. Jones has served as our General Counsel since August 1998 and Secretary since 2000. Mr. Jones is a partner with the law firm of Armbrust & Brown, L.L.P. and he provides legal and business advisory services under a consulting arrangement with his firm.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Performance Graph

The following graph compares the change in the cumulative total stockholder return on our common stock with the cumulative total return of the Hemscott Real Estate Development Group and the S&P 500 Stock

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Index from 2003 through 2007. This comparison assumes $100 invested on December 31, 2002 in (a) our common stock, (b) the Hemscott Real Estate Development Group and (c) the S&P 500 Stock Index.

Comparison of Cumulative Total Return*
Stratus Properties Inc., Hemscott Real Estate
Development Group and S&P 500 Stock Index

	December 31,					
	2002	2003	2004	2005	2006	2007
Stratus Properties Inc.	$ 100.00	$ 109.24	$ 174.24	$ 253.59	$ 347.83	$ 368.91
Hemscott Real Estate Development Group	100.00	166.91	290.84	306.54	298.04	193.65
S&P 500 Stock Index	100.00	128.68	142.69	149.70	173.34	182.87

* Total return assumes reinvestment of dividends.

Our common stock trades on the National Association of Securities Dealers Automated Quotation (NASDAQ) stock market under the symbol STRS. The following table sets forth, for the periods indicated, the range of high and low sales prices, as reported by NASDAQ.

	2007		2006	
	High	Low	High	Low
First Quarter	$35.00	$28.50	$24.96	$22.10
Second Quarter	40.73	29.96	26.98	24.01
Third Quarter	35.92	25.91	32.94	25.65
Fourth Quarter	36.33	27.37	33.00	25.72

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As of February 29, 2008, there were 621 holders of record of our common stock. We have not in the past paid, and do not anticipate in the future paying, cash dividends on our common stock. The decision whether or not to pay dividends and in what amounts is solely within the discretion of our Board of Directors. However, our current ability to pay dividends is also restricted by terms of our credit agreement, as discussed in Note 4.

The following table sets forth shares of our common stock that we repurchased during the three-month period ended December 31, 2007.

			Current Program[a]	
Period	Total Shares Purchased	Average Price Paid Per Share	Shares Purchased	Shares Available for Purchase
October 1 to 31, 2007	6,236	$31.98	6,236	429,710
November 1 to 30, 2007	1,349	28.70	1,349	428,361
December 1 to 31, 2007	4,000	31.39	4,000	424,361
Total	11,585	$31.40	11,585	

a. 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 our common stock repurchases after September 30, 2005. At December 31, 2007, $4.4 million remains available under the Comerica agreement for purchases of our common stock.

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Item 6. Selected Financial Data

The following table sets forth our selected historical financial data for each of the five years in the period ended December 31, 2007. The historical financial information is derived from our audited financial statements and is not necessarily indicative of our future results. In addition, the historical results have been adjusted to reflect the operations of Escarpment Village and Stratus 7000 West Joint Venture (7000 West) as discontinued operations (see Note 7). You should read the information in the table below together with Items 7. and 7A. "Management's Discussion and Analysis of Financial Condition and Results of Operation and Quantitative and Qualitative Disclosures About Market Risk" and Item 8. "Financial Statements and Supplementary Data."

	2007	2006	2005	2004	2003
	(In Dollars, Except Average Shares, and In Thousands, Except Per Share Amounts)				
Years Ended December 31:					
Revenues	$ 27,164	$ 61,875	$ 35,194	$ 17,725	$ 11,001
Operating income (loss)	2	23,349	8,336	338	(413)
Interest income	849	370	226	70	728
Equity in unconsolidated affiliates' income	488	-	-	-	29
Income from continuing operations	2,589	31,793	7,960	99	17
Income from discontinued operations, net of taxes	10,766a	8,495a, b	514b	573b	3b
Net income applicable to common stock	13,355	40,288	8,474	672	20
Basic net income per share:					
Continuing operations	$ 0.34	$ 4.35	$ 1.11	$ 0.01	$ -
Discontinued operations	1.43a	1.16a, b	0.07b	0.08b	-b
Basic net income per share	$ 1.77	$ 5.51	$ 1.18	$ 0.09	$ -
Diluted net income per share:					
Continuing operations	$ 0.34	$ 4.15	$ 1.04	$ 0.01	$ -
Discontinued operations	1.40a	1.11a, b	0.07b	0.08b	-b
Diluted net income per share	$ 1.74	$ 5.26	$ 1.11	$ 0.09	$ -
Average shares outstanding					
Basic	7,554	7,306	7,209	7,196	7,124
Diluted	7,677	7,658	7,636	7,570	7,315
At December 31:					
Working capital surplus (deficit)	$ 32,902	$ 3,230	$ (7,198)	$ (4,111)	$ (787)
Property held for sale	146,282	133,210	122,468	119,067	114,207
Property held for use, net	24,421	18,874	9,452	9,926	9,065
Assets from discontinued operations	-	34,917a	33,956a, b	19,961a, b	13,936b

Total assets	228,357	203,950	173,886	152,861	142,430
Long-term debt from continuing operations, including current portion	61,500	28,000	40,368	43,646	35,599
Long-term debt, from discontinued operations, including current portion	-	22,675a	21,731a, b	12,001a, b	11,940b
Stockholders' equity	152,400	133,946	94,167	88,196	86,821

a. Relates to the operations, assets and liabilities of Escarpment Village, which we sold in October 2007 (see Note 7).

b. Relates to the operations, assets and liabilities of 7000 West, which we sold in March 2006 (see Note 7).

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Items 7. and 7A. Management's Discussion and Analysis of Financial Condition and Results of Operation and Quantitative and Qualitative Disclosures About Market Risk

OVERVIEW

In management's discussion and analysis "we," "us," and "our" refer to Stratus Properties Inc. and its consolidated subsidiaries. You should read the following discussion in conjunction with our consolidated financial statements and the related discussion of "Business," "Risk Factors" and "Properties" included elsewhere in this Form 10-K. The results of operations reported and summarized below are not necessarily indicative of our future operating results. All subsequent references to Notes refer to Notes to Consolidated Financial Statements located in Item 8. "Financial Statements and Supplementary Data."

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 December 31, 2007, our most significant holding is the 1,678 acres of residential, multi-family and commercial property and 25 developed residential estate lots located within the Barton Creek community. We also own approximately 350 acres of undeveloped commercial property and approximately 37 acres of commercial property under development within the Circle C Ranch (Circle C) community. Our other properties in the Circle C community include Meridian, which is an 800-lot residential development. At December 31, 2007, Meridian consisted of approximately 249 acres under development and 58 developed residential lots. Our remaining Austin holdings at December 31, 2007, consisted of 223 acres of commercial property and two 75,000-square-foot office buildings, one of which is 90 percent leased and the other of which is approximately 94 percent leased, at 7500 Rialto Boulevard located within Lantana.

In January 2004, we acquired approximately 68 acres of land in Plano, Texas, which we refer to as Deerfield. At December 31, 2007, our Deerfield property consisted of the final 21 developed residential lots, which were sold in January 2008. We also own two acres of undeveloped commercial property in San Antonio, Texas.

In November 2005, we formed a joint venture partnership 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 completed brown field remediation and permitting of the property and are now proceeding with infrastructure development.

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 hotel, residential, retail, office and entertainment uses on approximately two acres. We have executed agreements with Starwood Hotels & Resorts Worldwide, Inc. for the development of a W Hotel and Residences on the site. On May 8, 2007, we announced our 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 of Austin (the City) and the grand opening for the onsite sales center was held in conjunction with the groundbreaking ceremony in October 2007.

In 2006, we sold our two 70,000-square-foot office buildings at 7000 West William Cannon Drive (7000 West), known as the Lantana Corporate Center for $22.3 million. On October 12, 2007, we sold Escarpment Village, which is a 168,000 square-foot retail center anchored by a grocery store in the Circle C community, for $46.5 million, before closing costs and other adjustments. Accordingly, we have reported 7000 West's and Escarpment Village's assets, liabilities and results of operations as discontinued operations (see "Discontinued Operations" and Note 7).

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Real Estate Market Conditions

Factors that significantly affect United States real estate market conditions include interest rate levels and the availability of financing, the supply of product (i.e. developed and/or undeveloped land, depending on buyers' needs) and current and anticipated future economic conditions. These market conditions historically move in periodic cycles, and can be volatile in specific regions. Because of the concentration of our assets primarily in the Austin, Texas area, market conditions in this region significantly affect our business.

In addition to the traditional influence of state and federal government employment levels on the local economy, in recent years the Austin area has experienced significant growth in the technology sector. The Austin-area population increased approximately 48 percent between 1989 and 1999, largely due to an influx of technology companies and related businesses. Average income levels in Austin also increased significantly during this period, rising by 62 percent. The booming economy resulted in rising demands for residential housing, commercial office space and retail services. Between 1989 and 1999, sales tax receipts in Austin rose by 126 percent, an indication of the dramatic increase in business activity during the period. The increases in population, income levels and sales tax revenues have been less dramatic over the last few years.

The following chart compares Austin's five-county metro area population and median family income for 1989 and 1999 and the most current information available for 2006 and 2007, based on U.S. Census Bureau data and City of Austin data.

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Based on the City of Austin's fiscal year of October 1st through September 30th, the chart below compares Austin's sales tax revenues for 1989, 1999 and 2006.

a. Source: Comprehensive Annual Financial Report for the City of Austin, Texas.

Real estate development in southwest Austin historically has been constrained as a result of various restrictions imposed by the City of Austin (the City). Several special interest groups have also traditionally opposed development in that area, where most of our property is located. 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. The December 31, 2006 and 2007 vacancy percentages for various types of developed properties in Austin are noted below.

	December 31,	
	2006	2007
Building Type	Vacancy Factor	
Industrial Buildings	12% a	6% a
Office Buildings (Class A)	13% b	14% a
Multi-Family Buildings	7% a	6% a
Retail Buildings	7% c	7% a

a. Texas A&M University Real Estate Center: Texas Market News
b. CB Richard Ellis: Austin Office MarketView
c. NAI Global Commercial Real Estate Services

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. In the fourth quarter of 2007, the real estate market in the United States began to show signs of weakness, as credit markets became unpredictable and mixed views developed regarding the economy. Our future performance may in part be dependent upon the credit markets settling and the underlying strength of the U.S. economy.

Over the past several years, we have successfully worked cooperatively with 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 opportunities, and believe we can obtain bank financing for developing our properties at a reasonable cost. See “Risk Factors” located in Item 1A.

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 hotel, residential, retail, office 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. On May 8, 2007, we announced our 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 the grand opening for the onsite sales center was held in conjunction with the groundbreaking ceremony in October 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 December 31, 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 December 31, 2007, we had leased approximately 94 percent of the space at the second office building and the original office building is 90 percent leased.

Barton Creek Community. In 2002, we secured subdivision plat approval for a new residential subdivision called Calera, which consists of 155 lots. At December 31, 2007, our remaining unsold developed lots within the Barton Creek Community included: Calera Drive – 8 lots, Amarra – 7 lots, Calera Court – 6 lots, Wimberly Lane Phase II – 2 lots and Mirador – 2 lots.

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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. The average purchase price for each of the 41 lots is $150,400, subject to a six percent annual escalator commencing in December 2004. As of December 31, 2007, the final two remaining lots are on schedule for sale in the first half of 2008.

During 2004, we began construction of courtyard homes at Calera Court, the initial phase of the Calera subdivision, which will include 16 homesites on 16 acres. The second phase of Calera, Calera Drive, consisting of 53 single-family lots, many of which adjoin 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 December 31, 2007, only eight 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 was completed in early 2008.

In the second quarter of 2007, we completed the first phase of the Barton Creek Village. The first phase includes a 22,000-square-foot retail building. In July 2007, we began construction of a 3,300-square-foot bank building within this retail complex, and it was completed in early 2008. Construction of the second retail building will begin by the second half of 2008.

Circle C Community. We are developing 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 was substantially completed in March 2006. Development of the 108-lot third phase of Meridian was completed in September 2007. The 118-lot fourth phase will commence in 2008 and completion is expected by the end of 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 the first quarter of 2008. 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 three phases of Meridian will total at least 30 lots for $2.0 million during the first quarter of 2008.

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 non-refundable option payment was applied against subsequent purchases of lots by the homebuilder after certain thresholds were achieved and was recognized by us as income as lots were sold. 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. In January 2008, we sold the final 21 lots for $1.4 million.

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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. The property, known as Crestview Station, is a single-family, multi-family, retail and office development, which is located on the commuter rail line approved by City of Austin voters. With Trammell Crow, we have completed brown field environmental remediation and permitting of the property and are now proceeding with infrastructure development. In September 2007, the State of Texas certified that the remediation was complete. At December 31, 2007, our investment in the Crestview Station project totaled $4.2 million and the joint venture partnership had $2.6 million of outstanding debt, of which each joint venture partner guarantees $1.3 million.

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):

	2007	2006	2005
Revenues:			
Real estate operations	$ 24,083	$ 60,213	$ 33,841
Commercial leasing	3,081	1,662	1,353
Total revenues	$ 27,164	$ 61,875	$ 35,194
Operating income	$ 2	$ 23,349	$ 8,336
(Provision for) benefit from income taxes	$ (1,670)	$ 8,344	$ (73)
Income from continuing operations	$ 2,589	$ 31,793	$ 7,960
Income from discontinued operations	10,766a	8,495b	514
Net income	$ 13,355	$ 40,288	$ 8,474

a. Includes a gain on sale of Escarpment Village $11.0 million, net of taxes of $5.1 million.
b. Includes a gain on sale of 7000 West of $8.3 million, net of taxes of $1.5 million.

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 2006, we sold 7000 West (see Note 7) and 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 the majority of our deferred tax assets. As a result, income from continuing operations for 2006 included an $8.3 million tax benefit, $1.14 per basic share and $1.09 per diluted share, 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 9). The following is a discussion of our operating results by segment.

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Real Estate Operations
Summary real estate operating results follow (in thousands):

	2007	2006	2005
Revenues:			
Developed property sales	$ 21,388	$ 33,459	$ 25,453
Undeveloped property sales	1,082	24,929	7,550
Commissions, management fees and other	1,613	1,825	838
Total revenues	24,083	60,213	33,841
Cost of sales, including depreciation	(15,754)	(29,223)	(19,770)
General and administrative expenses	(6,119)	(6,280)	(4,346)
Operating income	$ 2,210	$ 24,710	$ 9,725

Developed Property Sales. Property sales for the last three years follow (revenues in thousands):

	2007		2006		2005	
	Lots	Revenues	Lots	Revenues	Lots	Revenues
Residential Properties:						
Barton Creek						
Calera Drive	2	$ 809	24	$10,363	19	$7,101
Calera Court Courtyard Homes	2	1,307	5	2,922	2	945
Mirador Estate	3	2,334	7	3,791	7	3,912
Wimberly Lane Phase II						
Standard Homebuilder	12	2,114	11	1,804	10	1,564
Estate	-	-	-	-	6	1,851
Escala Drive Estate	-	-	1	695	9	4,882
Amarra Drive Phase I	1	1,250	-	-	-	-
Circle C						
Meridian	138	8,898	166	9,881	14	949
Deerfield	70	4,676	60	4,003	68	4,249
Total Residential	228	$21,388	274	$33,459	135	$25,453

Undeveloped Property Sales. During 2007, we sold a five-acre tract at Circle C for $1.1 million.

During 2006, we sold a 7.5-acre tract in the Barton Creek community for $1.5 million, a 58-acre tract at Lantana to AMD for $21.2 million of which $0.5 million represented a reimbursement of certain costs which we recorded as a reduction of cost of sales and an approximate 29-acre tract in Circle C for $2.7 million.

During 2005, we sold a 38-acre tract within the Barton Creek Community for $5.0 million and a 42-acre tract within the Circle C community for $2.6 million.

Commissions, Management Fees and Other. Commissions, management fees and other revenues totaled $1.6 million in 2007, compared to $1.8 million in 2006, and included sales of our development fee credits to third parties totaling $0.8 million in 2007 and $1.3 million in 2006. We received these development fee credits as part of the Circle C settlement (see Note 8).

Commissions, management fees and other revenues totaled $1.8 million in 2006, compared to $0.8 million in 2005, and included sales of our development fee credits to third parties totaling $1.3 million in 2006 and $0.5 million in 2005.

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Cost of Sales. Cost of sales totaled $15.8 million in 2007 and $29.2 million in 2006. Cost of sales for 2007 included reductions totaling $1.7 million for Barton Creek Municipal Utility District (MUD) reimbursements. Cost of sales for 2007 also decreased compared to 2006 primarily because of a decrease in developed property sales in 2007. Cost of sales increased to $29.2 million in 2006 from $19.8 million in 2005, primarily because of increases in lot sales and other land sales in 2006.

Commercial Leasing

Our commercial leasing operating results primarily reflect the activities at 7500 Rialto Boulevard. As of December 31, 2007, the original office building was 90 percent leased and the second building, which was completed in September 2006, was approximately 94 percent leased. Rental income increased in 2007 compared to 2006 primarily because of the increase in occupancy of the second office building during 2007; whereas, the second building was only 50 percent leased as of December 31, 2006. Rental income increased in 2006 compared to 2005 because of the completion and partial occupancy of the second office building during the second half of 2006. Summary commercial leasing operating results follow (in thousands):

	2007	2006	2005
Rental income	$ 3,081	$ 1,662	$ 1,353
Rental property costs	(3,264)	(1,718)	(1,456)
Depreciation	(1,115)	(725)	(613)
General and administrative expenses	(910)	(580)	(673)
Operating loss	$ (2,208)	$ (1,361)	$ (1,389)

Other Financial Results

General and administrative expenses increased to $7.0 million in 2007 from $6.9 million in 2006, primarily because of higher compensation costs. On January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), “Share-Based Payment” or “SFAS No. 123R.” Stock-based compensation costs charged to general and administrative expenses totaled $0.9 million in 2007, $0.8 million in 2006 and $0.3 million in 2005.

General and administrative expenses totaled $6.9 million in 2006 and $5.0 million in 2005. The increase in 2006 compared to 2005 primarily relates to higher compensation costs, including stock-based compensation costs.

Non-Operating Results

In connection with the sale of an oil and gas property in 1993, we indemnified the purchaser for any abandonment costs in excess of cumulative net revenues received. The property was subsequently sold to other parties, most recently in 2007. After assessing available information concerning the terms of the 2007 sale and the new purchaser’s future plans for the property, we concluded that our obligation to the seller still exists and did not transfer to the new purchaser. Additionally, we concluded that the new purchaser’s assumption of all abandonment obligations, along with its significant financial investment and expanded development plans for the property, make the likelihood of our being required to satisfy this contingent abandonment obligation remote. As a result, we reversed our $3.0 million reserve and recorded the same amount as other income in 2007.

Interest expense, net of capitalized interest, totaled $0.1 million in 2007, $0.3 million in 2006 and $0.5 million in 2005 (see Note 4). Capitalized interest totaled $2.8 million in 2007, $2.0 million in 2006 and $3.3 million in 2005. The decrease in net interest expense in 2007 is related to the financing for Escarpment Village project which is included in discontinued operations.

Interest income totaled $0.8 million in 2007, $0.4 million in 2006 and $0.2 million in 2005. Interest income included interest on Barton Creek Municipal Utility District (MUD) reimbursements totaling $0.5 million in 2007 and $0.1 million in each of 2006 and 2005.

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DISCONTINUED OPERATIONS

On October 12, 2007, we sold the Escarpment Village shopping center, located in Austin, Texas, to Lake Villa, L.L.C. (the Purchaser) for $46.5 million, before closing costs and other adjustments. The Purchaser paid $23.0 million in cash at closing and assumed the $22.4 million principal balance remaining under our loan from Teachers Insurance and Annuity Association of America (TIAA). We used a portion of the net proceeds from the sale to pay the outstanding balance on the $45.0 million Comerica revolving credit facility and will use the remainder of the net proceeds for general corporate purposes. We recorded a gain of $16.1 million ($11.0 million net of taxes or $1.46 per basic share and $1.43 per diluted share) on the sale.

Upon completion of the sale of Escarpment Village, we ceased all involvement with the Escarpment Village shopping center. The results of operations, assets and liabilities of Escarpment Village, which have been classified as discontinued operations in our consolidated financial statements, previously represented a component of our commercial leasing segment. We earned rental income from Escarpment Village totaling $2.8 million in 2007 and $2.1 million in 2006.

On March 27, 2006, we sold our two 70,000-square-foot office buildings at 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 ($8.3 million net of taxes or $1.13 per basic share and $1.08 per diluted share). 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, we 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. We earned rental income of $1.1 million in 2006 and $3.6 million in 2005 from the two fully leased office buildings at 7000 West.

Income from discontinued operations totaled $10.8 million, including an $11.0 million gain net of taxes on the Escarpment Village sale, in 2007, and $8.5 million, including a $7.3 million gain net of taxes on the 7000 West sale in 2006.

CAPITAL RESOURCES AND LIQUIDITY

Comparison Of Year-To-Year Cash Flows

Operating activities provided cash of $25.7 million in 2007, $44.3 million in 2006 and $37.4 million in 2005, including cash provided by (used in) discontinued operations totaling $10.3 million in 2007, $(5.3) million in 2006 and $3.2 million in 2005. Compared to 2006, operating cash flows in 2007 improved primarily because of the sale of Escarpment Village. Compared to 2005, operating cash flows in 2006 improved primarily because of the increase in sales activities.

Cash used in investing activities totaled $22.9 million in 2007, including $10.9 million provided by discontinued operations (see “Discontinued Operations” and Note 7). Cash used in investing activities totaled $41.9 million in 2006 including $2.5 million of cash provided by discontinued operations. Cash used in investing activities totaled $39.3 million in 2005, including $14.7 million used in discontinued operations. In December 2006, we acquired approximately two acres comprising a city block in downtown Austin, Texas, for $15.1 million. Other real estate development expenditures for 2007 and 2006 included development costs for properties in the Barton Creek, Lantana and Circle C communities. Expenditures for commercial leasing properties for 2007 primarily related to the first retail building at Barton Creek Village. Commercial leasing expenditures for 2006 primarily related to the second building at 7500 Rialto Boulevard, which was completed in September 2006. In 2005, development of our commercial leasing

properties included the completion of certain tenant improvements to our 7500 Rialto Boulevard office building. Expenditures were partly offset by MUD reimbursements of $2.6 million in 2007, $1.3 million in 2006 and $4.6 million in 2005.

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Our financing activities in 2007 include $15.0 million of borrowings under our unsecured term loans, $21.5 million of borrowings under the new Lantana promissory note and $3.0 million of net repayments on our revolving line of credit. In 2007, we also used $1.5 million to repurchase shares of our common stock on the open market. During 2006, our financing activities included net repayments of $12.7 million on our revolving line of credit and net repayments of $14.4 million on our project construction loans. In December 2006, we entered into two separate new loan agreements with First American Asset Management (FAAM) to borrow $15.0 million to fund the purchase of the land being used in connection with our Block 21 project. Financing activities provided cash of $3.4 million in 2005, including net cash provided by discontinued operations totaling $9.7 million. During 2005, our financing activities reflected $4.7 million of net payments under our revolving line of credit and $1.4 million of net borrowings from our project construction loans. See "Credit Facility and Other Financing Arrangements" below for a discussion of our outstanding debt at December 31, 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 2007, we purchased 45,449 shares for $1.5 million, a $31.97 per share average. During the first quarter of 2008 through March 10, 2008, we purchased 8,575 shares for $0.3 million, a $29.37 per share average. As of March 10, 2008, a total of 415,786 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 $4.2 million is currently available. 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.

The following table summarizes our contractual cash obligations as of December 31, 2007 (in thousands):

	2008	2009	2010	2011	2012	Thereafter	Total
Debt	$ 242	$ 279	$ 297	$ 40,315	$ 334	$ 20,033	$ 61,500
Construction contracts	11,674	-	-	-	-	-	11,674
Operating lease	154	38	5	-	-	-	197
Total	$ 12,070	$ 317	$ 302	$ 40,315	$ 334	$ 20,033	$ 73,371

We had commitments under noncancelable open contracts totaling $11.7 million at December 31, 2007. These commitments include the following contracts that we entered into in 2007:

Thirteen contracts totaling $3.9 million for infrastructure work in connection with new residential subdivisions at Barton Creek with a remaining balance of $0.3 million at December 31, 2007;
A $2.5 million contract for the construction of a 20,000 square-foot retail center at Circle C with a remaining balance of $1.1 million at December 31, 2007;
Three contracts totaling $1.3 million for the final three condominium units at Calera Court in Barton Creek with the entire balance remaining at December 31, 2007;
A $3.8 million contract for infrastructure work in connection with new residential subdivisions at Meridian in Circle C with a remaining balance of $1.2 million at December 31, 2007; and
$14.3 million in contracts in connection with architectural, design and engineering work for Block 21 with a remaining balance of $7.6 million at December 31, 2007.

In addition to the contracts noted above, we also had $0.1 million of outstanding commitments at December 31, 2007, on other ongoing Lantana, Meridian and Barton Creek development contracts.

In early 2008, we entered into additional contracts for $2.7 million for infrastructure work associated with new residential subdivisions at Barton Creek and an additional $0.7 million in contracts related to Block 21.

For a further discussion of our debt obligations, see “Credit Facility and Other Financing Arrangements” below.

Credit Facility and Other Financing Arrangements

A summary of our outstanding borrowings (in thousands) and a discussion of our financing arrangements follow.

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	December 31,	
	2007	2006
Unsecured term loans	$ 40,000	$ 25,000
Lantana Promissory Note	21,500	-
TIAA mortage	-	22,675a
Comerica revolving credit facility	-	3,000
Total debt	$ 61,500	$ 50,675

a. Assumed by purchaser of Escarpment Village.

Credit Facility. We established a banking relationship with Comerica in 1999 that has substantially enhanced our financial flexibility. In September 2005, we replaced our $30.0 million credit facility with a $45.0 million Comerica revolving credit facility, which sets limitations on liens and transactions with affiliates and requires that certain financial ratios be maintained. The facility allows us to purchase up to $6.5 million of our outstanding common stock after September 30, 2005. In May 2006, we entered into a modification and extension agreement to extend the maturity and decrease the interest rate on the Comerica revolving credit facility. In May 2007, we entered into another modification and extension agreement to extend the maturity and further decrease the interest rate on the revolving credit facility. The $45.0 million facility, of which $3.0 million is provided for our Calera Court project, matures on May 30, 2009. Interest on the facility now accrues, at our option, at Comerica's rate minus 1.10 percent or London Interbank Offered Rate (LIBOR) plus 1.65 percent, subject to a minimum annual rate of 5.0 percent. Security for obligations outstanding under the facility includes our properties within the Barton Creek community and certain of our properties within Lantana and the Circle C community. At December 31, 2007, no amounts were outstanding under the revolving credit facility.

Unsecured Term Loans. We have $40.0 million of borrowings outstanding under seven unsecured term loans with First American Asset Management (FAAM), 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.

In December 2006, we amended our two unsecured $5.0 million term loans with FAAM. The amended agreements extend the maturities of both loans and decrease the annual interest rates on both loans to 6.56 percent.

In December 2006, we also entered into two separate new loan agreements with FAAM to borrow an additional $15.0 million to purchase the land being used in connection with our Block 21 project. Amounts borrowed under both loans bear interest at an annual rate of 6.56 percent.

In June 2007, we entered into three separate loan agreements with 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, and the remainder was used for operations, capital expenditures and other development costs, including Block 21.

The loan agreements contain customary financial covenants and other restrictions. 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.

Lantana Promissory Note. On December 14, 2007, our wholly owned subsidiary, Lantana Office Properties I, L.P., ("Lantana"), signed a promissory note to The Lincoln National Life Insurance Company. Under the terms of the note, Lantana borrowed $21.5 million, which will be used for development costs and general corporate purposes. The note matures on January 1, 2018. The note contains customary financial covenants and other restrictions. The note bears interest at a rate of 5.99 percent per year.

Prepayment of the note is prohibited prior to February 1, 2010. Prepayment of the note in whole, subsequent to February 1, 2010, is subject to a prepayment premium of the greater of (1) one percent of the outstanding principal balance of the note on the prepayment date or (2) the result of the sum of the present values of the remaining payments due from the prepayment date through the maturity date minus the outstanding principal balance of the note as of the prepayment date. Prepayment of the note in part is

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prohibited. Repayments under the note can be accelerated by the lender upon the occurrence of certain customary events of default. Lantana's obligations under the note are secured by a first lien on real property and improvements and an assignment of rents and present and future leases related to the office buildings at 7500 Rialto Boulevard.

CRITICAL ACCOUNTING POLICIES

Management's discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States of America. The preparation of these statements requires that we make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. We base these estimates on historical experience and on assumptions that we consider reasonable under the circumstances; however, reported results could differ from those based on the current estimates under different assumptions and/or conditions. The areas requiring the use of management's estimates are discussed in Note 1 to our consolidated financial statements under the heading "Use of Estimates." We believe that our most critical accounting policies relate to our valuation of investment real estate and commercial leasing assets, our allocation of indirect costs, revenue recognition and valuation allowances for deferred tax assets.

Management has reviewed the following discussion of its development and selection of critical accounting estimates with the Audit Committee of our Board of Directors.

- Investment in Real Estate and Commercial Leasing Assets. Real estate held for sale is stated at the lower of cost or fair value less costs to sell and includes acreage, development, construction and carrying costs and other related costs through the development stage. Commercial leasing assets, which are held for use, are stated at cost. When events or circumstances indicate than an asset's carrying amount may not be recoverable, an impairment test is performed in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." For properties held for sale, if estimated fair value less costs to sell is less than the related carrying amount, then a reduction of the assets carrying value to fair value less costs to sell is required. For properties held for use, if the projected undiscounted cash flow from the asset is less than the related carrying amount, then a reduction of the carrying amount of the asset to fair value is required. Measurement of the impairment loss is based on the fair value of the asset. Generally, we determine fair value using valuation techniques such as discounted expected future cash flows.

Our expected future cash flows are affected by many factors including:
- The economic condition of the Austin, Texas, market;
- The performance of the real estate industry in the markets where our properties are located;
- Our financial condition, which may influence our ability to develop our real estate; and
- Governmental regulations.

Because any one of these factors could substantially affect our estimate of future cash flows, this is a critical accounting policy because these estimates could result in us either recording or not recording an impairment loss based on different assumptions. Impairment losses are generally substantial charges. We have not recorded any such impairment charges since recording a $115 million charge in 1994. Any impairment charge would more likely than not have a material effect on our results of operations.

The estimate of our future revenues is also important because it is the basis of our development plans and also a factor in our ability to obtain the financing necessary to complete our development plans. If our estimates of future cash flows from our properties differ from expectations, then our financial and liquidity position may be compromised, which could result in our default under certain debt instruments or result in our suspending some or all of our development activities.

- Allocation of Overhead Costs. We periodically capitalize a portion of our overhead costs and also allocate a portion of these overhead costs to cost of sales based on the activities of our employees that are directly engaged in these activities. In order to accomplish this procedure, we periodically evaluate our “corporate” personnel activities to see what, if any, time is associated with activities that would normally be

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capitalized or considered part of cost of sales. After determining the appropriate aggregate allocation rates, we apply these factors to our overhead costs to determine the appropriate allocations. This is a critical accounting policy because it affects our net results of operations for that portion which is capitalized. In accordance with paragraph 7 of SFAS No. 67, "Accounting for Costs and Initial Rental Operations of Real Estate Projects," we only capitalize direct and indirect project costs associated with the acquisition, development and construction of a real estate project. Indirect costs include allocated costs associated with certain pooled resources (such as office supplies, telephone and postage) which are used to support our development projects, as well as general and administrative functions. Allocations of pooled resources are based only on those employees directly responsible for development (i.e. project manager and subordinates). We charge to expense indirect costs that do not clearly relate to a real estate project such as salaries and allocated expenses related to the Chief Executive Officer and Chief Financial Officer.

We recognize our rental income based on the terms of our signed leases with tenants on a straight-line basis. We recognize sales commissions and management and development fees when earned, as lots or acreage are sold or when the services are performed.

- Deferred Tax Assets. Our deferred tax assets at December 31, 2005, totaled $19.5 million primarily from net operating loss credit carryforwards, and we had provided a 100 percent valuation allowance because realization of the deferred tax assets was not considered likely (see Note 5). In 2006, we sold 7000 West (see Note 7) and 58 acres at our Lantana property. These transactions generated pre-tax income of $25.6 million and along with our current homebuilder contract arrangements and projected levels of future sales provide sufficient evidence that we now believe it is more likely than not that we will be able to realize the majority of our deferred tax assets. At December 31, 2007, our net deferred tax assets totaled $6.9 million, net of $0.2 million valuation allowance. Realization of our deferred tax assets is dependent on generating sufficient taxable income within the carryforward period available under tax law. Should actual results differ materially from our estimates, we may need to reinstate a valuation allowance, which could materially impact our results of operations and financial position in future periods.

DISCLOSURES ABOUT MARKET RISKS

We derive our revenues from the management, development and sale of our real estate holdings and rental of our office properties. Our results of operations can vary significantly with fluctuations in the market prices of real estate, which are influenced by numerous factors, including interest rate levels. Changes in interest rates also affect interest expense on our debt. At the present time, we do not hedge our exposure to changes in interest rates. At December 31, 2007, $40.0 million of our total outstanding debt of $61.5 million bears interest at variable rates. A change of 100 basis points in annual interest rates for this variable-rate debt would have an approximate $0.4 million impact on annual interest costs.

ENVIRONMENTAL

Increasing emphasis on environmental matters is likely to result in additional costs. Our future operations may require substantial capital expenditures, which could adversely affect the development of our properties and results of operations. Additional costs will be charged against our operations in future periods when such costs can be reasonably estimated. We cannot at this time accurately predict the costs associated with future environmental obligations. See "Risk Factors."

NEW ACCOUNTING STANDARDS

Accounting for Uncertainty in Income Taxes. On January 1, 2007, we adopted Financial Accounting Standards Board (FASB) Interpretation No. 48, "Accounting for Uncertainty in Income Taxes," (FIN 48), which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken

or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. We did not recognize a change to our unrecognized tax benefits as a result of the implementation of FIN 48. The adoption of FIN 48 had no impact on our financial statements. We had no unrecognized tax benefits as of January 1, 2007 or December 31, 2007.

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Fair Value Measurements. In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," which provides enhanced guidance for using fair value to measure assets and liabilities. SFAS No. 157 does not require any new fair value measurements under U.S. generally accepted accounting principles (GAAP); rather this statement establishes a common definition of fair value, provides a framework for measuring fair value under U.S. GAAP and expands disclosure requirements about fair value measurements. On February 12, 2008, the FASB issued FSP FAS 157-2, which delays the effective date of SFAS No. 157 for nonfinancial assets or liabilities that are not required or permitted to be measured at fair value on a recurring basis to fiscal years beginning after November 15, 2008, and interim periods within those years. We are currently evaluating the impact, if any, the adoption of SFAS No. 157 will have on our financial reporting and disclosures.

Fair Value Option for Financial Assets and Liabilities. 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," which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We do not believe that the adoption of SFAS No. 159 will have a material impact on our financial reporting and disclosures.

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 Item 1 of this Form 10-K.

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Item 8. Financial Statements and Supplementary Data

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

TO THE BOARD OF DIRECTORS AND STOCKHOLDERS OF STRATUS PROPERTIES INC.:

In our opinion, the consolidated financial statements listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the financial position of Stratus Properties Inc. and its subsidiaries at December 31, 2007 and 2006, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2007 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007 based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements and financial statement schedule, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express opinions on these financial statements, on the financial statement schedule, and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note 1 to the consolidated financial statements, the Company changed the manner in which it accounts for share-based compensation in 2006.

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may

deteriorate.

/s/ PricewaterhouseCoopers LLP
Austin, Texas
March 14, 2008

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MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Stratus Properties Inc.'s (the Company's) management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) or 15d-15(f) under the Securities Exchange Act of 1934 as a process designed by, or under the supervision of, the Company's principal executive and principal financial officers and effected by the Company's Board of Directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the Company's assets;

- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and

- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management, including our principal executive officer and principal financial officer, assessed the effectiveness of our internal control over financial reporting as of the end of the fiscal year covered by this annual report on Form 10-K. In making this assessment, our management used the criteria set forth in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on our management's assessment, management concluded that, as of December 31, 2007, our Company's internal control over financial reporting is effective based on the COSO criteria.

PricewaterhouseCoopers LLP, an independent registered public accounting firm, has issued their audit report on our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2007, as stated in their report dated March 14, 2008, which is included herein.

/s/ William H. Armstrong III	/s/ John E. Baker
William H. Armstrong III	John E. Baker
Chairman of the Board, President	Senior Vice President
and Chief Executive Officer	and Chief Financial Officer

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STRATUS PROPERTIES INC.
CONSOLIDATED BALANCE SHEETS
(In Thousands, Except Par Value)

	December 31,	
	2007	2006
ASSETS		
Current assets:		
Cash and cash equivalents, including restricted cash of $112 and $116, respectively	$ 40,985	$ 1,736
Accounts receivable	2,315	839
Notes receivable from property sales	311	26
Deposits, prepaid expenses and other	79	56
Deferred tax asset	1,401	1,144
Discontinued operations (Note 7)	-	34,917
Total current assets	45,091	38,718
Real estate, commercial leasing assets and facilities, net:		
Property held for sale – developed or under development	129,759	116,865
Property held for sale – undeveloped	16,523	16,345
Property held for use, net	24,421	18,874
Investment in unconsolidated affiliate	4,226	3,800
Deferred tax asset	5,534	7,105
Other assets	2,803	2,243
Total assets	$ 228,357	$ 203,950
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	$ 6,324	$ 5,676
Accrued interest, property taxes and other	5,623	5,134
Current portion of long-term debt	242	-
Discontinued operations (Note 7)	-	24,678
Total current liabilities	12,189	35,488
Long-term debt (Note 4)	61,258	28,000
Other liabilities	2,510	6,516
Total liabilities	75,957	70,004
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Preferred stock, par value $0.01 per share, 50,000 shares authorized and unissued	-	-
Common stock, par value $0.01 per share, 150,000 shares authorized, 8,128 and 8,057 shares issued, respectively and 7,542 and 7,531 shares outstanding, respectively	81	81
Capital in excess of par value of common stock	195,898	188,873
Accumulated deficit	(29,300)	(42,655)

Common stock held in treasury, 586 shares and 526 shares, at cost, respectively	(14,279)	(12,353)
Total stockholders’ equity	152,400	133,946
Total liabilities and stockholders' equity	$ 228,357	$ 203,950

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

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

	Years Ended December 31,		
	2007	2006	2005
Revenues:			
Real estate	$ 22,470	$ 58,388	$ 33,003
Rental income	3,081	1,662	1,353
Commissions, management fees and other	1,613	1,825	838
Total revenues	27,164	61,875	35,194
Cost of sales (Note 1):			
Real estate, net	15,597	29,096	19,625
Rental	3,264	1,718	1,456
Depreciation	1,272	852	758
Total cost of sales	20,133	31,666	21,839
General and administrative expenses	7,029	6,860	5,019
Total costs and expenses	27,162	38,526	26,858
Operating income	2	23,349	8,336
Other income	3,000	-	-
Interest expense, net	(80)	(270)	(529)
Interest income	849	370	226
Equity in unconsolidated affiliate’s income	488	-	-
Income from continuing operations before income taxes	4,259	23,449	8,033
(Provision for) benefit from income taxes	(1,670)	8,344	(73)
Income from continuing operations	2,589	31,793	7,960
Income from discontinued operations, net of taxes (Note 7)	10,766	8,495	514
Net income applicable to common stock	$ 13,355	$ 40,288	$ 8,474
Basic net income per share of common stock:			
Continuing operations	$ 0.34	$ 4.35	$ 1.11
Discontinued operations	1.43	1.16	0.07
Basic net income per share of common stock	$ 1.77	$ 5.51	$ 1.18
Diluted net income per share of common stock:			
Continuing operations	$ 0.34	$ 4.15	$ 1.04
Discontinued operations	1.40	1.11	0.07
Diluted net income per share of common stock	$ 1.74	$ 5.26	$ 1.11
Average shares of common stock outstanding:			
Basic	7,554	7,306	7,209
Diluted	7,677	7,658	7,636

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

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

	Years Ended December 31,		
	2007	2006	2005
Cash flow from operating activities:			
Net income	$ 13,355	$ 40,288	$ 8,474
Adjustments to reconcile net income to net cash provided by operating activities:			
Income from discontinued operations	(10,766)	(8,495)	(514)
Depreciation	1,272	852	758
Cost of real estate sold	14,262	23,827	17,057
Deferred income taxes	1,314	(6,431)	-
Stock-based compensation	1,534	1,095	310
Equity in unconsolidated affiliate’s income	(488)	-	-
Deposits	(1,372)	272	(274)
Long-term notes receivable	-	-	789
Other long-term liabilities	(3,000)	-	-
Other	(759)	986	1,021
(Increase) decrease in working capital:			
Accounts receivable, prepaid expenses and other	(1,788)	(656)	(366)
Accounts payable, accrued liabilities and other	1,767	(2,131)	6,991
Net cash provided by continuing operations	15,331	49,607	34,246
Net cash provided by (used in) discontinued operations	10,333	(5,289)	3,178
Net cash provided by operating activities	25,664	44,318	37,424
Cash flow from investing activities:			
Purchases and development of real estate properties	(34,528)	(36,278)	(25,058)
Development of commercial leasing properties and other expenditures	(1,896)	(9,513)	(284)
Municipal utility district reimbursements	2,557	1,337	4,600
Investment in unconsolidated affiliate	-	-	(3,800)
Net cash used in continuing operations	(33,867)	(44,454)	(24,542)
Net cash provided by (used in) discontinued operations	10,930	2,520	(14,715)
Net cash used in investing activities	(22,937)	(41,934)	(39,257)
Cash flow from financing activities:			
Borrowings from revolving credit facility	17,450	18,000	55,005
Payments on revolving credit facility	(20,450)	(30,677)	(59,684)
Borrowings from unsecured term loans	15,000	15,000	-
Borrowings from Lantana promissory note	21,500	-	-
Borrowings from project loans	-	1,214	7,647
Repayments on project loans	-	(15,593)	(6,248)
Net (payments for) proceeds from exercised stock options	(112)	(2,438)	639
Excess tax benefit from exercised stock options	4,845	1,111	-
Purchases of Stratus common shares	(1,453)	(565)	(3,342)

Bank credit facility fees	-	(810)	(388)
Net cash provided by (used in) continuing operations	36,780	(14,758)	(6,371)
Net cash (used in) provided by discontinued operations	(258)	12,428	9,731
Net cash provided by (used in) financing activities	36,522	(2,330)	3,360

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

	Years Ended December 31,		
	2007	2006	2005
Net increase in cash and cash equivalents	39,249	54	1,527
Cash and cash equivalents at beginning of year	1,736	1,901	379
Cash and cash equivalents at end of year	40,985	1,955	1,906
Less cash restricted as to use	(112)	(116)	(387)
Less cash at discontinued operations	-	(219)	(336)
Unrestricted cash and cash equivalents at end of year	$ 40,873	$ 1,620	$ 1,183
Supplemental Information:			
Interest paid	$ 1,146	$ 1,071	$ 1,085
Income taxes paid	$ -	$ 952	$ -

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

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STRATUS PROPERTIES INC.
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(In Thousands)

	Years Ended December 31,		
	2007	2006	2005
Preferred stock:			
Balance at beginning and end of year	$ -	$ -	$ -
Common stock:			
Balance at beginning of year representing 8,057 shares in 2007, 7,485 shares in 2006 and 7,284 shares in 2005	81	74	72
Exercise of stock options and restricted stock representing 71 shares in 2007, 572 shares in 2006 and 201 shares in 2005	-	7	2
Balance at end of year representing 8,128 shares in 2007, 8,057 shares in 2006 and 7,485 shares in 2005	81	81	74
Capital in excess of par value:			
Balance at beginning of year	188,873	182,007	181,145
Stock-based compensation expense, net of capitalized amounts	1,534	1,095	36
Exercised stock options and other	646	4,660	826
Tax benefit for stock option exercises	4,845	1,111	-
Balance at end of year	195,898	188,873	182,007
Accumulated deficit:			
Balance at beginning of year	(42,655)	(82,943)	(91,417)
Net income	13,355	40,288	8,474
Balance at end of year	(29,300)	(42,655)	(82,943)
Unamortized value of restricted stock units:			
Balance at beginning of year	-	(567)	(841)
Reclass unamortized value of restricted stock units on adoption of new accounting standard	-	567	-
Amortization of related deferred compensation, net of forfeitures	-	-	274
Balance at end of year	-	-	(567)
Common stock held in treasury:			
Balance at beginning of year representing 526 shares in 2007, 268 shares in 2006 and 63 shares in 2005	(12,353)	(4,404)	(763)
Shares purchased representing 45 shares in 2007,			

23 shares in 2006 and 189 shares in 2005		(1,453)		(565)		(3,342)
Tender of 15 shares in 2007, 235 shares in 2006 and 16 shares in 2005 for exercised stock options and restricted stock		(473)		(7,384)		(299)
Balance at end of year representing 586 shares in 2007, 526 shares in 2006 and 268 shares in 2005		(14,279)		(12,353)		(4,404)
Total stockholders' equity	$	152,400	$	133,946	$	94,167

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

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STRATUS PROPERTIES INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Operations and Basis of Accounting. The real estate development and marketing operations of Stratus Properties Inc. (Stratus), a Delaware Corporation, are conducted primarily in Austin, Texas, through its wholly owned subsidiaries and through an unconsolidated joint venture (see "Investment in Unconsolidated Affiliate" below and Note 3). Stratus consolidates its wholly owned subsidiaries, which include: Stratus Properties Operating Co., L.P.; Circle C Land, L.P.; Lantana Office Properties I, L.P.; Austin 290 Properties, Inc.; Avalon Realty Company, L.L.C.; Stratus Management L.L.C.; Stratus Realty Inc.; Longhorn Properties Inc.; Stratus Investments L.L.C., STRS Plano, L.P., Southwest Property Services L.L.C., Stratus Block 21 Investments, L.P., Calera Court, L.P.; Meridian Development L.P.; Oly Stratus Barton Creek I JV and STRS L.L.C. All significant intercompany transactions have been eliminated in consolidation. On March 27, 2006, Stratus sold Stratus 7000 West Joint Venture (7000 West) and on October 12, 2007, Stratus sold the Escarpment Village shopping center. As a result, 7000 West and Escarpment Village are reported as discontinued operations and the consolidated financial statements for all periods have been adjusted to reflect this presentation (see Note 7).

Investment in Unconsolidated Affiliate. Stratus has a 50 percent interest in the Crestview Station project (see Note 3), which it accounts for under the equity method in accordance with the provisions of the American Institute of Certified Accountants Statement of Position 78-9, "Accounting for Investments in Real Estate Ventures." Stratus has determined that consolidation of the Crestview Station project is not required under the provisions of Financial Accounting Standards Board Interpretation No. 46, "Consolidation of Variable Interest Entities."

Use of Estimates. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in these financial statements and accompanying notes. The more significant estimates include estimates of future cash flow from development and sale of real estate properties, allocation of certain indirect costs, valuation allowances for deferred tax assets, useful lives for depreciation and amortization and abandonment costs for a previously owned oil and gas property. Actual results could differ from those estimates.

Cash Equivalents and Restricted Cash. Highly liquid investments purchased with maturities of three months or less are considered cash equivalents. Restricted cash includes $0.1 million held at December 31, 2007 and 2006, for payment of fractional shares resulting from the May 2001 stock split (see Note 6).

Financial Instruments. The carrying amounts of receivables, accounts payable and long-term debt reported in the accompanying consolidated balance sheets approximate fair value. Stratus periodically evaluates its ability to collect its receivables. Stratus provides an allowance for estimated uncollectible amounts if its evaluation provides sufficient evidence of such amounts. Stratus believes all of its receivables are collectible and no allowances for doubtful accounts are included in the accompanying consolidated balance sheets.

Investment in Real Estate and Commercial Leasing Assets. Real estate held for sale is stated at the lower of cost or fair value less costs to sell, and includes acreage, development, construction and carrying costs, and other related costs through the development stage. Commercial leasing assets, which are held for use, are stated at cost. Capitalized costs are assigned to individual components of a project, as practicable, whereas interest and other common costs are allocated based on the relative fair value of individual land parcels. Certain carrying costs are capitalized on properties currently under active development. Stratus recorded capitalized interest of $2.8 million in 2007, $2.0 million in 2006 and $3.3 million in 2005.

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In accordance with Statement of Financial Accounting Standards (SFAS) No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets,” when events or circumstances indicate that an asset’s carrying amount may not be recoverable, an impairment test is performed. Events or circumstances that Stratus considers indicators of impairment include significant decreases in market values, adverse changes in regulatory requirements (including environmental laws) and current period or projected operating cash flow losses from rental properties. Impairment tests for properties to be held and used, including rental properties, involve the use of estimated future net undiscounted cash flows expected to be generated from the use of the property and its eventual disposition. If projected undiscounted cash flow from properties to be held and used is less than the related carrying amount, then a reduction of the carrying amount of the long-lived asset to fair value is required. Measurement of the impairment loss is based on the fair value of the asset. Generally, Stratus determines fair value using valuation techniques such as discounted expected future cash flows. Impairment tests for properties held for sale, including undeveloped and developed properties, involve management estimates of fair value based on estimated market values for similar properties in similar locations and management estimates of costs to sell. If estimated fair value less costs to sell is less than the related carrying amount, then a reduction of the long-lived asset to fair value less costs to sell is required. No impairment losses are reflected in the accompanying consolidated statements of income.

Accrued Property Taxes. Stratus estimates its property tax accrual based on prior year property tax payments and other current events that may impact the payment. Upon receipt of the property tax bill, Stratus adjusts its accrued property tax balance at year-end to the actual amount of taxes due in January. Accrued property taxes totaled $1.6 million at December 31, 2007 and $2.0 million at December 31, 2006.

Depreciation. Office buildings are depreciated on a straight-line basis over their estimated 40-year life. Furniture, fixtures and equipment are depreciated on a straight-line basis over a five-year period.

Revenue Recognition. Revenues from property sales are recognized in accordance with SFAS No. 66, “Accounting for Sales of Real Estate,” when the risks and rewards of ownership are transferred to the buyer, when the consideration received can be reasonably determined and when Stratus has completed its obligations to perform certain supplementary development activities, if any exist, at the time of the sale. Consideration is reasonably determined and considered likely of collection when Stratus has signed sales agreements and has determined that the buyer has demonstrated a commitment to pay. The buyer’s commitment to pay is supported by the level of their initial investment, Stratus’ assessment of the buyer’s credit standing and Stratus’ assessment of whether the buyer’s stake in the property is sufficient to motivate the buyer to honor their obligation to it.

Stratus recognizes its rental income based on the terms of its signed leases with tenants on a straight-line basis. Stratus recognizes sales commissions and management and development fees when earned, as lots or acreage are sold or when the services are performed. A summary of Stratus’ revenues follows:

	Years Ended December 31,		
	2007	2006	2005
		(In Thousands)	
Revenues:			
Developed property sales	$ 21,388	$ 33,459	$ 25,453
Undeveloped property sales	1,082	24,929	7,550
Rental income	3,081	1,662	1,353
Commissions, management fees and other	1,613	1,825	838
Total revenues	$ 27,164	$ 61,875	$ 35,194

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Cost of Sales. Cost of sales includes the cost of real estate sold as well as costs directly attributable to the properties sold such as marketing and depreciation. A summary of Stratus' cost of sales follows:

	Years Ended December 31,		
	2007	2006	2005
		(In Thousands)	
Cost of developed property sales	$ 14,106	$ 19,627	$ 13,023
Cost of undeveloped property sales	326	7,473	4,564
Rental property costs	3,264	1,718	1,456
Allocation of overhead costs (see below)	3,235	2,811	2,277
Municipal utility district reimbursements (see below)	(1,724)	(92)	(126)
Depreciation	1,272	852	758
Other, net	(346)	(723)	(113)
Total cost of sales	$ 20,133	$ 31,666	$ 21,839

Municipal Utility District Reimbursements. Stratus receives Barton Creek Municipal Utility District (MUD) reimbursements from the City of Austin (the City) for certain infrastructure costs incurred. Prior to 1996, Stratus expensed infrastructure costs as incurred. In 1996, Stratus began capitalizing the infrastructure costs to the related properties. MUD reimbursements received for infrastructure costs incurred prior to 1996 are reflected as a reduction of cost of sales, while other MUD reimbursements represent a reimbursement of basis in real estate properties and are recorded as a reduction of the related asset's balance. Stratus has agreements with seven independent MUDs in Barton Creek to build the MUDs' utility systems and to be eligible for future reimbursements for the related costs. The amount and timing of MUD reimbursements depends upon the respective MUD having a sufficient tax base within its district to issue bonds and being able to obtain the necessary state approval for the sale of the bonds. Because the timing of the issuance and approval of the bonds is subject to considerable uncertainty, coupled with the fact that interest rates on such bonds cannot be fixed until they are approved, the amounts associated with MUD reimbursements are not known until approximately one month before the MUD reimbursements are received. MUD reimbursements represent the actual amounts received.

Allocation of Overhead Costs. Stratus has historically allocated a portion of its overhead costs to both capital accounts (real estate, commercial leasing assets and facilities) and cost of sales based on the percentage of time certain of its employees, comprising its indirect overhead pool, worked in the related areas (i.e. construction and development for capital and sales and marketing for cost of sales). In accordance with paragraph 7 of SFAS No. 67, "Accounting for Costs and Initial Rental Operations of Real Estate Projects," Stratus only capitalizes direct and indirect project costs associated with the acquisition, development, and construction of a real estate project. Indirect costs include allocated costs associated with certain pooled resources (such as office supplies, telephone and postage) which are used to support Stratus' development projects, as well as general and administrative functions. Allocations of pooled resources are based only on those employees directly responsible for development (i.e. project manager and subordinates). Stratus charges to expense indirect costs that do not clearly relate to a real estate project, such as salaries and allocated expenses related to the Chief Executive Officer and Chief Financial Officer.

Advertising Costs. Advertising costs are expensed as incurred and are included as a component of cost of sales. Advertising costs totaled $0.3 million in 2007, $0.2 million in 2006 and $0.2 million in 2005.

Income Taxes. Stratus follows the liability method of accounting for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes." Under this method, deferred tax assets and liabilities are recorded for future tax consequences of temporary differences between the financial reporting and tax basis of assets and liabilities (see Note

5).

Earnings Per Share. Stratus' basic net income per share of common stock was calculated by dividing the income applicable to continuing operations, income from discontinued operations and net income applicable to common stock by the weighted average number of common shares outstanding during the year. 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):

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	Years Ended December 31,		
	2007	2006	2005
Income from continuing operations	$ 2,589	$ 31,793	$ 7,960
Income from discontinued operations	10,766	8,495	514
Net income applicable to common stock	$ 13,355	$ 40,288	$ 8,474
Weighted average common shares outstanding	7,554	7,306	7,209
Add: Dilutive stock options	97	314	418
Restricted stock	26	38	9
Weighted average common shares outstanding for purposes of calculating diluted net income per share	7,677	7,658	7,636
Diluted net income per share of common stock:			
Continuing operations	$ 0.34	$ 4.15	$ 1.04
Discontinued operations	1.40	1.11	0.07
Diluted net income per share of common stock	$ 1.74	$ 5.26	$ 1.11

Stock-Based Compensation Plans. As of December 31, 2007, Stratus has two stock-based employee compensation plans and one stock-based director compensation plan, which are more fully described in Note 6. Prior to January 1, 2006, Stratus accounted for options granted under all of its plans under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, “Accounting for Stock Issued to Employees,” and related interpretations, as permitted by SFAS No. 123, “Accounting for Stock-Based Compensation.” APB Opinion No. 25 required compensation cost for stock options to be recognized based on the difference on the date of grant, if any, between the quoted market price of the stock and the amount an employee must pay to acquire the stock (i.e., the intrinsic value). Because all the plans require that the option exercise price be at least the market price on the date of grant, Stratus recognized no compensation cost on the grant or exercise of its employees’ options through December 31, 2005. Prior to 2007, Stratus defined the market price as the average of the high and low price of Stratus common stock on the date of grant. Effective March 2007, in response to new Securities and Exchange Commission disclosure rules, Stratus now defines the market price for future grants as the closing price of Stratus common stock on the date of grant. Other awards of restricted stock units under the plans did result in compensation costs being recognized in earnings based on the intrinsic value on the date of grant.

Effective January 1, 2006, Stratus adopted the fair value recognition provisions of SFAS No. 123 (revised 2004), “Share-Based Payment” or “SFAS No. 123R,” using the modified prospective transition method. Under that transition method, compensation cost recognized in 2007 and 2006 includes: (a) compensation costs for all stock option awards granted to employees prior to but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123, and (b) compensation costs for all stock option awards granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123R. In addition, other stock-based awards charged to expense under SFAS No. 123 (i.e., restricted stock units) continue to be charged to expense under SFAS No. 123R. Results for prior periods have not been restated. Stratus has elected to recognize compensation costs for awards that vest over several years on a straight-line basis over the vesting period. Stratus’ stock option awards provide for employees to receive the next year’s vesting after an employee retires. For stock option awards granted after January 1, 2006, to retirement-eligible employees, Stratus records one year of amortization of the awards’ value on the date of grant. In addition, prior to adoption of SFAS No. 123R, Stratus recognized forfeitures as they occurred in its SFAS No. 123 pro forma disclosures. Beginning January 1, 2006, Stratus includes estimated forfeitures in its compensation cost and updates the estimated forfeiture rate

through the final vesting date of the awards.

As a result of adopting SFAS No. 123R on January 1, 2006, Stratus' net income for the year ended December 31, 2006, was $0.7 million ($0.10 per basic share and $0.09 per diluted share) lower than if it had continued to account for share-based compensation under APB Opinion No. 25.

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The following table illustrates the effect on net income and earnings per share for the year ended December 31, 2005, if Stratus had applied the fair value recognition provisions of SFAS No. 123 to stock-based awards granted under Stratus' stock-based compensation plans (in thousands, except per share amounts):

Net income applicable to common stock, as reported	$	8,474				
Add: Stock-based employee compensation expense included in reported net income applicable to common stock for restricted stock units		274				
Deduct: Total stock-based employee compensation expense determined under fair value-based method for all awards		(937)				
Pro forma net income applicable to common stock	$	7,811				
Earnings per share:						
Basic – as reported	$	1.18				
Basic – pro forma	1,660,271		$53,226	$41,402	$—	$1,754,899
Loans Acquired With Deteriorated Credit Quality (Included in the Total Above)	$	2,604	$1,647	$3,978	$—	$8,229

The Company considers the performance of the loan portfolio and its impact on the allowance for loan losses. For home equity, consumer and residential mortgage loan classes, the Company also evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following table presents the recorded investment in home equity, consumer and residential mortgage loans based on payment activity as of March 31, 2018 and December 31, 2017:

March 31, 2018	Home Equity Loans	Consumer Loans	Residential Mortgage Loans
Performing	$152,339	$ 64,584	$ 177,621
Nonperforming	188	71	916
Total	$152,527	$ 64,655	$ 178,537
Loans Acquired With Deteriorated Credit Quality (Included in the Total Above)	$—	$ —	$ 878

December 31, 2017	Home Equity Loans	Consumer Loans	Residential Mortgage Loans
Performing	$152,558	$ 67,361	$ 178,712
Nonperforming	199	286	487
Total	$152,757	$ 67,647	$ 179,199
Loans Acquired With Deteriorated Credit Quality (Included in the Total Above)	$—	$ —	$ 888

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GERMAN AMERICAN BANCORP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2018
(unaudited, dollars in thousands except share and per share data)

NOTE 6 - Loans (continued)

The Company has purchased loans, for which there was, at acquisition, evidence of deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected. The recorded investment of those loans is as follows:

	March 31, 2018	December 31, 2017
Commercial and Industrial Loans	$ 790	$ 988
Commercial Real Estate Loans	6,194	6,452
Agricultural Loans	957	789
Residential Mortgage Loans	878	888
Total	$ 8,819	$ 9,117
Carrying Amount, Net of Allowance	$ 8,778	$ 9,106

Accretable yield, or income expected to be collected, is as follows:

	2018	2017
Balance at January 1	$2,734	$2,521
New Loans Purchased	—	—
Accretion of Income	(81)	(42)
Reclassifications from Non-accretable Difference	86	311
Charge-off of Accretable Yield	—	—
Balance at March 31	$2,739	$2,790

For those purchased loans disclosed above, the Company increased the allowance for loan losses by $30 and $11 during the three months ended March 31, 2018 and 2017. No allowance for loan losses were reversed during the same period.

The carrying amount of consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process according to local requirements of the applicable jurisdiction totaled $28 as of March 31, 2018 and $14 as of December 31, 2017.

GERMAN AMERICAN BANCORP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2018
(unaudited, dollars in thousands except share and per share data)

NOTE 7 – Repurchase Agreements Accounted for as Secured Borrowings

Repurchase agreements are short-term borrowings included in FHLB Advances and Other Borrowings and mature overnight and continuously. Repurchase agreements, which were secured by mortgage-backed securities, totaled $31,796 and $41,499 as of March 31, 2018 and December 31, 2017, respectively. Risk could arise when the collateral pledged to a repurchase agreement declines in fair value. The Company minimizes risk by consistently monitoring the value of the collateral pledged. At the point in time where the collateral has declined in fair value, the Company is required to provide additional collateral based on the value of the underlying securities.

NOTE 8 – Segment Information

The Company’s operations include three primary segments: core banking, trust and investment advisory services, and insurance operations. The core banking segment involves attracting deposits from the general public and using such funds to originate consumer, commercial and agricultural, commercial and agricultural real estate, and residential mortgage loans, primarily in the Company’s local markets. The core banking segment also involves the sale of residential mortgage loans in the secondary market. The trust and investment advisory services segment involves providing trust, investment advisory, and brokerage services to customers. The insurance segment offers a full range of personal and corporate property and casualty insurance products, primarily in the Company’s banking subsidiary’s local markets.

The core banking segment is comprised by the Company’s banking subsidiary, German American Bancorp, which operated through 53 banking offices at March 31, 2018. Effective April 1, 2018, the legal name of German American Bancorp was changed to German American Bank. Net interest income from loans and investments funded by deposits and borrowings is the primary revenue for the core-banking segment. The trust and investment advisory services segment’s revenues are comprised primarily of fees generated by the trust operations of the Company's banking subsidiary and by German American Investment Services, Inc. These fees are derived by providing trust, investment advisory, and brokerage services to its customers. The insurance segment primarily consists of German American Insurance, Inc., which provides a full line of personal and corporate insurance products. Commissions derived from the sale of insurance products are the primary source of revenue for the insurance segment.

The following segment financial information has been derived from the internal financial statements of the Company which are used by management to monitor and manage financial performance. The accounting policies of the three segments are the same as those of the Company. The evaluation process for segments does not include holding company income and expense. Holding company amounts are the primary differences between segment amounts and consolidated totals, and are reflected in the column labeled “Other” below, along with amounts to eliminate transactions between segments.

	Core Banking	Trust and Investment Advisory Services	Insurance	Other	Consolidated Totals
Three Months Ended March 31, 2018					
Net Interest Income	$ 25,790	$ 3	$ 2	$ (185)	$ 25,610
Net Gains on Sales of Loans	650	—	—	—	650
Net Gains on Securities	270	—	—	—	270

Trust and Investment Product Fees	2	1,771	—	—	1,773
Insurance Revenues	1	2	2,927	—	2,930
Noncash Items:					
Provision for Loan Losses	350	—	—	—	350
Depreciation and Amortization	1,115	1	19	64	1,199
Income Tax Expense (Benefit)	2,244	136	321	(217)	2,484
Segment Profit (Loss)	10,762	385	939	(273)	11,813
Segment Assets at March 31, 2018	3,126,137	2,461	11,165	(14,745)	3,125,018

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NOTE 8 - Segment Information (continued)

	Core Banking	Trust and Investment Advisory Services	Insurance	Other	Consolidated Totals
Three Months Ended March 31, 2017					
Net Interest Income	$ 24,909	$ 1	$ 2	$ (187)	$ 24,725
Net Gains on Sales of Loans	687	—	—	—	687
Net Gains on Securities	—	—	—	—	—
Trust and Investment Product Fees	1	1,244	—	(2)	1,243
Insurance Revenues	2	5	2,633	—	2,640
Noncash Items:					
Provision for Loan Losses	500	—	—	—	500
Depreciation and Amortization	1,041	3	19	64	1,127
Income Tax Expense (Benefit)	3,622	34	427	(262)	3,821
Segment Profit (Loss)	8,965	44	673	(126)	9,556
Segment Assets at December 31, 2017	3,142,096	1,987	10,078	(9,801)	3,144,360

NOTE 9 – Stock Repurchase Plan

On April 26, 2001, the Company announced that its Board of Directors approved a stock repurchase program for up to 911,631 of the outstanding shares of common stock of the Company. Shares may be purchased from time to time in the open market and in large block privately negotiated transactions. The Company is not obligated to purchase any shares under the program, and the program may be discontinued at any time before the maximum number of shares specified by the program are purchased. The Board of Directors established no expiration date for this program. As of March 31, 2018, the Company had purchased 502,447 shares under the program. No shares were purchased under the program during the three months ended March 31, 2018 and 2017.

NOTE 10 – Equity Plans and Equity Based Compensation

The Company maintains three equity incentive plans under which stock options, restricted stock, and other equity incentive awards can be granted. At March 31, 2018, the Company has reserved 386,754 shares of common stock for the purpose of issuance pursuant to outstanding and future grants of options, restricted stock, and other equity awards to officers, directors and other employees of the Company.

For the three months ended March 31, 2018 and 2017, the Company granted no options. The Company recorded no stock compensation expense applicable to options during the three months ended March 31, 2018 and 2017 because all outstanding options were fully vested prior to 2007. In addition, there was no unrecognized option expense.

During the periods presented, awards of long-term incentives were granted in the form of restricted stock. Awards that were granted to management under a management incentive plan were granted in tandem with cash credit

entitlements (typically in the form of 60% restricted stock grants and 40% cash credit entitlements). The management and employee restricted stock grants and tandem cash credit entitlements awarded will vest in three equal installments of 33.3% with the first annual vesting on December 5th of the year of the grant and on December 5th of the next two succeeding years. Awards that were granted to directors as additional retainer for their services do not include any cash credit entitlement. These director restricted stock grants are subject to forfeiture in the event that the recipient of the grant does not continue in service as a director of the Company through December 5th of the year after grant or does not satisfy certain meeting attendance requirements, at which time they generally vest 100 percent. For measuring compensation costs, restricted stock awards are valued based upon the market value of the common shares on the date of grant. During the three months ended March 31, 2018 and 2017, the Company granted awards of 34,860 and 37,890 shares of restricted stock, respectively. Total unvested restricted stock awards at March 31, 2018 and December 31, 2017 were 80,716 and 46,306, respectively.

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NOTE 10 - Equity Plans and Equity Based Compensation (continued)

The following table presents expense recorded for restricted stock and cash entitlements as well as the related tax information for the periods presented:

	Three Months Ended March 31,	
	2018	2017
Restricted Stock Expense	$278	$306
Cash Entitlement Expense	170	158
Tax Effect	(117)	(182)
Net of Tax	$331	$282

Unrecognized expense associated with the restricted stock grants and cash entitlements totaled $3,449 and $3,201 as of March 31, 2018 and 2017, respectively.

The Company maintains an Employee Stock Purchase Plan whereby eligible employees have the option to purchase the Company's common stock at a discount. The purchase price of the shares under this Plan has been set at 95% of the fair market value of the Company's common stock as of the last day of the plan year. The plan provided for the purchase of up to 750,000 shares of common stock, which the Company may obtain by purchases on the open market or from private sources, or by issuing authorized but unissued common shares. At March 31, 2018, there were 557,203 shares available for future issuance under this plan. Funding for the purchase of common stock is from employee and Company contributions.

There was no expense recorded for the employee stock purchase plan during the three months ended March 31, 2018 and 2017. There was no unrecognized compensation expense as of March 31, 2018 and 2017 for the Employee Stock Purchase Plan.

NOTE 11 – Fair Value

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Company used the following methods and significant assumptions to estimate the fair value of each type of financial instrument:

Investment Securities: The fair values for investment securities are determined by quoted market prices, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3). Level 3 pricing is obtained from a third-party based upon similar trades that are not traded frequently without adjustment by the Company. At March 31, 2018, the Company held $5.5 million in Level 3 securities which consist of $5.2 million of non-rated Obligations of State and Political Subdivisions and $353 thousand of equity securities that are not actively traded. Absent the credit rating, significant assumptions must be made such that the credit risk input becomes an unobservable input and thus these securities are reported by the Company in a Level 3 classification.

Derivatives: The fair values of derivatives are based on valuation models using observable market data as of the measurement date (Level 2).

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NOTE 11 - Fair Value (continued)

Impaired Loans: Fair values for impaired collateral dependent loans are generally based on appraisals obtained from licensed real estate appraisers and in certain circumstances includes consideration of offers obtained to purchase properties prior to foreclosure. Appraisals for commercial real estate generally use three methods to derive value: cost, sales or market comparison and income approach. The cost method bases value in the cost to replace the current property. Value of market comparison approach evaluates the sales price of similar properties in the same market area. The income approach considers net operating income generated by the property and an investor's required return. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Comparable sales adjustments are based on known sales prices of similar type and similar use properties and duration of time that the property has been on the market to sell. Such adjustments made in the appraisal process are typically significant and result in a Level 3 classification of the inputs for determining fair value.

Appraisals for both collateral-dependent impaired loans and other real estate owned are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by the Company. Once received, a member of the Company’s Risk Management Area reviews the assumptions and approaches utilized in the appraisal. In determining the value of impaired collateral dependent loans and other real estate owned, significant unobservable inputs may be used which include: physical condition of comparable properties sold, net operating income generated by the property and investor rates of return.

Other Real Estate: Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate (ORE) are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property utilizing similar techniques as discussed above for Impaired Loans, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, impairment loss is recognized.

Loan Servicing Rights: On a quarterly basis, loan servicing rights are evaluated for impairment based upon the fair value of the rights as compared to carrying amount resulting in a Level 2 classification. The valuation model utilizes interest rate, prepayment speed, and default rate assumptions that market participants would use in estimating future net servicing income and that can be validated against available market data.

Loans Held-for-Sale: The fair values of loans held for sale are determined by using quoted prices for similar assets, adjusted for specific attributes of that loan resulting in a Level 2 classification.

Assets and Liabilities Measured on a Recurring Basis

Assets and liabilities measured at fair value on a recurring basis, including financial assets and liabilities for which the Company has elected the fair value option, are summarized below:

	Fair Value Measurements at March 31, 2018 Using			
	Quoted Prices in Active Markets	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total

	for Identical Assets (Level 1)			
Assets:				
Obligations of State and Political Subdivisions	$ —	$ 267,582	$ 5,171	$ 272,753
MBS/CMO - Residential	—	464,851	—	464,851
Equity Securities	—	—	353	353
Total Securities	$ —	$ 732,433	$ 5,524	$ 737,957
Loans Held-for-Sale	$ —	$ 6,628	$ —	$ 6,628
Derivative Assets	$ —	$ 2,232	$ —	$ 2,232
Mortgage Servicing Rights	$ —	$ 531	$ —	$ 531
Derivative Liabilities	$ —	$ 2,210	$ —	$ 2,210

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NOTE 11 - Fair Value (continued)

	Fair Value Measurements at December 31, 2017 Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Assets:				
Obligations of State and Political Subdivisions	$ —	$ 267,660	$ 5,649	$ 273,309
MBS/CMO - Residential	—	467,332	—	467,332
Equity Securities	—	—	353	353
Total Securities	$ —	$ 734,992	$ 6,002	$ 740,994
Loans Held-for-Sale	$ —	$ 6,719	$ —	$ 6,719
Derivative Assets	$ —	$ 1,564	$ —	$ 1,564
Mortgage Servicing Rights	$ —	$ 547	$ —	$ 547
Derivative Liabilities	$ —	$ 1,633	$ —	$ 1,633

There were no transfers between Level 1 and Level 2 for the periods ended March 31, 2018 and December 31, 2017.

At March 31, 2018, the aggregate fair value of the Loans Held-for-Sale was $6,628. Aggregate contractual principal balance was $6,478 with a difference of $150. At December 31, 2017, the aggregate fair value of the Loans Held-for-Sale was $6,719. Aggregate contractual principal balance was $6,576 with a difference of $143.

The tables below present a reconciliation of all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three months ended March 31, 2018 and 2017:

	Obligations of State and Political Subdivisions		Equity Securities	
	2018	2017	2018	2017
Balance of Recurring Level 3 Assets at January 1	$ 5,649	$ 7,566	$ 353	$ 353
Total Gains or Losses Included in Other Comprehensive Income	(18)	17	—	—
Maturities / Calls	(460)	(865)	—	—
Purchases	—	—	—	—
Balance of Recurring Level 3 Assets at March 31	$ 5,171	$ 6,718	$ 353	$ 353

Of the total gain/loss included in earnings for the three months ended March 31, 2018 and 2017, ($18) and $17 was attributable to other changes in fair value, respectively.

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NOTE 11 - Fair Value (continued)

Assets and Liabilities Measured on a Non-Recurring Basis

Assets and liabilities measured at fair value on a non-recurring basis are summarized below:

	Fair Value Measurements at March 31, 2018 Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Assets:				
Impaired Loans				
Commercial and Industrial Loans	$ —	$ —	$ 2,853	$ 2,853
Commercial Real Estate Loans	—	—	3,240	3,240

	Fair Value Measurements at December 31, 2017 Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Assets:				
Impaired Loans				
Commercial and Industrial Loans	$ —	$ —	$ 3,354	$ 3,354
Commercial Real Estate Loans	—	—	3,438	3,438

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of $7,274 with a valuation allowance of $1,181, resulting in a decrease to the provision for loan losses of $1,047 for the period ended March 31, 2018. For the three months ended March 31, 2017, impaired loans resulted in an increase to the provision for loan losses of $278. Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of $9,020 with a valuation allowance of $2,228, resulting in an increase to the provision for loan losses of $1,973 for the year ended December 31, 2017.

There was no Other Real Estate carried at fair value less costs to sell at March 31, 2018. No charge to earnings was included in the three months ended March 31, 2018 and 2017. There was no Other Real Estate carried at fair value less costs to sell at December 31, 2017. No charge to earnings was included in the year ended December 31, 2017.

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at March 31, 2018 and December 31, 2017:

March 31, 2018	Fair Value	Unobservable Input(s)

		Valuation Technique(s)		Range (Weighted Average)
Impaired Loans - Commercial and Industrial Loans	$ 2,853	Sales comparison approach	Adjustment for physical condition of comparable properties sold	0%-95% (88%)
Impaired Loans - Commercial Real Estate Loans	$ 3,240	Sales comparison approach	Adjustment for physical condition of comparable properties sold	17%-76% (47%)

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NOTE 11 - Fair Value (continued)

December 31, 2017	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted Average)
Impaired Loans - Commercial and Industrial Loans	$ 3,354	Sales comparison approach	Adjustment for physical condition of comparable properties sold	0%-95% (84%)
Impaired Loans - Commercial Real Estate Loans	$ 3,438	Sales comparison approach	Adjustment for physical condition of comparable properties sold	30%-76% (47%)

The carrying amounts and estimated fair values of the Company's financial instruments not previously presented are provided in the tables below for the periods ending March 31, 2018 and December 31, 2017. Not all of the Company's assets and liabilities are considered financial instruments, and therefore are not included in the tables. Because no active market exists for a significant portion of the Company's financial instruments, fair value estimates were based on subjective judgments, and therefore cannot be determined with precision. In accordance with the adoption of ASU 2016-01, the tables below present the fair values measured using an exit price notion. The fair value of loans as of December 31, 2017 was measured using an entrance price notion.

		Fair Value Measurements at March 31, 2018 Using			
	Carrying Value	Level 1	Level 2	Level 3	Total
Financial Assets:					
Cash and Short-term Investments	$ 40,210	$32,023	$8,187	$ —	$40,210
Loans, Net	2,129,993	—	—	2,099,154	2,099,154
FHLB Stock and Other Restricted Stock	13,048	N/A	N/A	N/A	N/A
Accrued Interest Receivable	13,633	—	3,885	9,748	13,633
Financial Liabilities:					
Demand, Savings, and Money Market Deposits	(2,064,524)	(2,064,524)	—	—	(2,064,524)
Time Deposits	(402,597)	—	(401,234)	—	(401,234)
Short-term Borrowings	(142,796)	—	(142,796)	—	(142,796)
Long-term Debt	(131,677)	—	(118,619)	(10,709)	(129,328)
Accrued Interest Payable	(952)	—	(886)	(66)	(952)

		Fair Value Measurements at December 31, 2017 Using			
	Carrying Value	Level 1	Level 2	Level 3	Total
Financial Assets:					
Cash and Short-term Investments	$ 70,359	$48,467	$16,349	$ —	$64,816
Loans, Net	2,119,152	—	—	2,120,154	2,120,154
FHLB Stock and Other Restricted Stock	13,048	N/A	N/A	N/A	N/A
Accrued Interest Receivable	13,258	—	3,574	9,684	13,258
Financial Liabilities:					
Demand, Savings, and Money Market Deposits	(2,096,167)	(1,096,167)	—	—	(1,096,167)
Time Deposits	(387,885)	—	(388,640)	—	(388,640)

Short-term Borrowings	(133,499)	—	(133,499)	—	(133,499)
Long-term Debt	(141,717)	—	(129,366)	(11,052)	(140,418)
Accrued Interest Payable	(1,058)	—	(1,042)	(16)	(1,058)

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NOTE 12 - Other Comprehensive Income (Loss) (continued)

NOTE 12 - Other Comprehensive Income (Loss)

The tables below summarize the changes in accumulated other comprehensive income (loss) by component for the three months ended March 31, 2018 and 2017, net of tax:

March 31, 2018	Unrealized Gains and Losses on Available-for-Sale Securities	Postretirement Benefit Items	Total
Beginning Balance at January 1, 2018	$ (2,335)	$ (285)	$(2,620)
Other Comprehensive Income (Loss) Before Reclassification	(9,005)	—	(9,005)
Amounts Reclassified from Accumulated Other Comprehensive Income (Loss)	(213)	—	(213)
Net Current Period Other Comprehensive Income (Loss)	(9,218)	—	(9,218)
Ending Balance at March 31, 2018	$ (11,553)	$ (285)	$(11,838)

March 31, 2017	Unrealized Gains and Losses on Available-for-Sale Securities	Postretirement Benefit Items	Total
Beginning Balance at January 1, 2017	$ (6,312)	$ (92)	$(6,404)
Other Comprehensive Income (Loss) Before Reclassification	3,998	—	3,998
Amounts Reclassified from Accumulated Other Comprehensive Income (Loss)	—	—	—
Net Current Period Other Comprehensive Income (Loss)	3,998	—	3,998
Ending Balance at March 31, 2017	$ (2,314)	$ (92)	$(2,406)

The tables below summarize the classifications out of accumulated other comprehensive income (loss) by component for the three months ended March 31, 2018 and 2017:

Details about Accumulated Other Comprehensive Income (Loss) Components	Amount Reclassified From Accumulated Other Comprehensive Income (Loss)	Affected Line Item in the Statement Where Net Income is Presented
Unrealized Gains and Losses on Available-for-Sale Securities	$ 270	Net Gains on Securities
	(57)	Income Tax Expense
	213	Net of Tax
Total Reclassifications for the Three Months Ended March 31, 2018	$ 213	

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NOTE 12 - Other Comprehensive Income (Loss) (continued)

Details about Accumulated Other Comprehensive Income (Loss) Components	Amount Reclassified From Accumulated Other Comprehensive Income (Loss)		Affected Line Item in the Statement Where Net Income is Presented
Unrealized Gains and Losses on Available-for-Sale Securities	$	—	Net Gains on Securities
	—		Income Tax Expense
	—		Net of Tax
Total Reclassifications for the Three Months Ended March 31, 2017	$	—	

NOTE 13 - Newly Issued Accounting Pronouncements

In January 2016, the FASB amended existing guidance (ASU 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities) that requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. Also, it requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. It requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables). It eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value for financial instruments measured at amortized cost. These amendments are effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within that reporting period. The Company notes that the impact of adoption is to carry the equity security at fair value or at cost, less impairment when fair value is not readily determinable, with observable price changes being recognized in earnings. The Company adopted ASU 2016-01 on January 1, 2018 and no adjustment to the single equity security was performed upon adoption. Also, upon adoption of ASU 2016-01, this equity security is no longer classified as available-for-sale. For additional information on this equity security, see Note 4 - Securities. Per ASU 2016-01 guidance, the Company reported the fair value of financial instruments based upon an exit price notion for March 31, 2018. For additional information, see Note 11 - Fair Value.

In August 2016, the FASB issued ASU (ASU No. 2016-15, Statement of Cash Flows (Topic 320): Classification of Certain Cash Receipts and Cash Payments) to address the diversity in how certain cash receipts and cash payments are presented and classified in the statement of cash flows including the following:

- Debt Prepayment or Debt Extinguishment Costs;
- Settlement of Zero-Coupon Bonds or Debt with Coupon Interest Rates That Are Insignificant in Relation to the Effective Interest Rate;
- Contingent Consideration payments Made Soon After a Business Combination;
- Proceeds From the Settlement of Insurance Claims;

- Proceeds From the Settlement of BOLI and COLI Policies;
- Distributions Received From Equity Method Investees;
- Beneficial Interests in Securitization Transactions; and
- Application of the Predominance Principle.

These amendments are effective for public business entities beginning January 1, 2018. The Company adopted ASU 2016-15 on January 1, 2018 and there was no material impact on the Company's Consolidated Statements of Cash Flows.

In March 2017, the FASB amended existing guidance (ASU No. 2017-07, Compensation - Retirement Benefits (Topic 715)) to improve the presentation of net periodic pension cost and net periodic postretirement benefit cost. The amendments require that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit costs are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. The amendments are effective for public business entities beginning January 1, 2018. The Company adopted ASU 2017-07 on January 1, 2018 and there was no material impact on the Company's Consolidated Statements of Income.

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NOTE 13 - Newly Issued Accounting Pronouncements (continued)

In February 2016, the FASB amended existing guidance (ASU No. 2016-02, Leases (Topic 842)) that requires lessees recognize the following for all leases (with the exception of short-term leases) at the commencement date (1) A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. These amendments are effective for public business entities for fiscal years beginning after December 15, 2018, including interim periods within that reporting period. Based on our leases outstanding as of March 31, 2018, the Company does not expect this new guidance to have a material impact on the consolidated results of operation. However as a result of this new guidance, the Company anticipates an estimated increase in its Consolidated Balance Sheet of approximately $6,000. This impact will vary based on the Company's future decisions to enter into new lease agreements or exit/renew current lease agreements prior to the date of implementation.

In June 2016, the FASB issued guidance (ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326)) to replace the incurred loss model with an expected loss model, which is referred to as the current expected credit loss (CECL) model. The CECL model is applicable to the measurement of credit losses on financial assets measured at amortized cost, including loan receivables, held-to-maturity debt securities, and reinsurance receivables. It also applies to off-balance sheet credit exposures not accounted for as insurance (loan commitments, standby letters of credit, financial guarantees, and other similar instruments) and net investments in leases recognized by a lessor. This standard will be effective for public business entities for fiscal years beginning after December 15, 2019, including interim periods within that reporting period.

The transition to the new standard will be applied as follows:

- For debt securities with other-than-temporary impairment (OTTI), the guidance will be applied prospectively.
- Existing purchased credit impaired (PCI) assets will be grandfathered and classified as purchased credit deteriorated (PCD) assets at the date of adoption. The asset will be grossed up for the allowance for expected credit losses for all PCD assets at the date of adoption and will continue to recognize the noncredit discount in interest income based on the yield of such assets as of the adoption date. Subsequent changes in expected credit losses will be recorded through the allowance.
- For all other assets within the scope of CECL, a cumulative-effect adjustment will be recognized in retained earnings as of the beginning of the first reporting period in which the guidance is effective.

The Company has formed a CECL committee that is assessing data and system needs in order to evaluate the impact of adopting the new guidance. The Company expects to recognize a one-time cumulative adjustment to the allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective, but cannot estimate the amount at this time.

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NOTE 14 – Subsequent Events

On February 12, 2018, German American Bancorp (now known as German American Bank) entered into a Purchase and Assumption Agreement (the "Purchase Agreement") with MainSource Bank, a wholly-owned subsidiary of MainSource Financial Group, Inc. ("MainSource"), which provides for the acquisition by German American Bank of five MainSource Bank branch locations (four in Columbus, Indiana, and one in Greensburg, Indiana), and certain related assets, and the assumption by German American Bank of certain related liabilities.

Pursuant to the Purchase Agreement, German American Bank has agreed to assume approximately $160 million in deposits and purchase approximately $134 million in loans associated with the five bank branches. German American Bank has agreed to pay a purchase price equal to the sum of: (i) 8.0% of the balances of certain checking accounts and other demand withdrawal accounts (excluding governmental accounts with public funds); (ii) 4.5% of the balances of governmental accounts with public funds, excluding time deposits; (iii) 4.5% of the balances of money market and savings deposits, excluding governmental accounts with public funds; (iv) the net book value of all assets, including loans but excluding any accrued interest on such loans; and (v) the accrued interest with respect to purchased loans. The purchase price will be adjusted to reflect increases or decreases in the deposit balances during the six month period following the closing date. Upon written notice, German American Bank will also have the ability to put loans back to MainSource Bank during such six month period. The expected premium to be paid for deposits under the Agreement is approximately $8 million. German American Bank is also assuming the obligations of MainSource Bank related to certain leases covering the five bank branches.

With the previously-announced merger of MainSource and First Financial Bancorp having been completed on April 1, 2018 and all necessary regulatory approvals having been received, the transaction is expected to close on May 18, 2018, subject to other customary closing conditions.

Effective April 1, 2018, the legal name of German American Bancorp was changed to German American Bank. The new name corresponds with the trade name already being used by the banking subsidiary and promotes further distinction in nomenclature between the banking subsidiary and the bank holding company, German American Bancorp, Inc.

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

GERMAN AMERICAN BANCORP, INC.
MANAGEMENT’S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

German American Bancorp, Inc., is a NASDAQ-traded (symbol: GABC) financial services holding company based in Jasper, Indiana. German American Bancorp, Inc., through its banking subsidiary German American Bank, operates 53 banking offices in 19 contiguous southern Indiana counties and one northern Kentucky county. Prior to April 1, 2018, German American Bank was known as German American Bancorp. The Company also owns an investment brokerage subsidiary (German American Investment Services, Inc.) and a full line property and casualty insurance agency (German American Insurance, Inc.).

Throughout this Management’s Discussion and Analysis, as elsewhere in this Report, when we use the term “Company,” we will usually be referring to the business and affairs (financial and otherwise) of German American Bancorp, Inc. and its subsidiaries and affiliates as a whole. Occasionally, we will refer to the term “parent company” or “holding company” when we mean to refer to only German American Bancorp, Inc.

This section presents an analysis of the consolidated financial condition of the Company as of March 31, 2018 and December 31, 2017 and the consolidated results of operations for the three months ended March 31, 2018 and 2017. This discussion should be read in conjunction with the consolidated financial statements and other financial data presented elsewhere herein and with the financial statements and other financial data, as well as the Management’s Discussion and Analysis of Financial Condition and Results of Operations, included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

MANAGEMENT OVERVIEW

This updated discussion should be read in conjunction with the Management Overview that was included in our Management’s Discussion and Analysis of Financial Condition and Results of Operations in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

Net income for the quarter ended March 31, 2018 totaled $11,813,000, or $0.51 per share, an increase of 21% on a per share basis compared with the first quarter 2017 net income of $9,556,000, or $0.42 per share. The first quarter of 2018 net income was positively impacted by lower federal income tax rates that became effective January 1, 2018 as a result of the Tax Act (as discussed and defined below). The lower federal income tax rates had a positive impact of approximately $0.06 per share during the first quarter of 2018.

On December 22, 2017, the U.S. government enacted comprehensive tax reform legislation commonly referred to as the Tax Cuts and Jobs Act of 2017 (the “Tax Act”). Among other things, the Tax Act includes significant changes to the U.S. corporate income tax system, including: reducing the federal corporate rate from 35% to 21%; modifying the rules regarding limitations on certain deductions for executive compensation; introducing a capital investment deduction in certain circumstances; placing certain limitations on the interest deduction; and modifying the rules regarding the usability of net operating losses.

On February 12, 2018, German American Bancorp (now known as German American Bank) entered into a Purchase and Assumption Agreement (the “Purchase Agreement”) with MainSource Bank, a wholly-owned subsidiary of MainSource Financial Group, Inc. (“MainSource”), which provides for the acquisition by German American Bank of five MainSource Bank branch locations (four in Columbus, Indiana, and one in Greensburg, Indiana), and certain related assets, and the assumption by German American Bank of certain related liabilities.

Pursuant to the Purchase Agreement, German American Bank has agreed to assume approximately $160 million in deposits and purchase approximately $134 million in loans associated with the five bank branches. With the previously-announced merger of MainSource and First Financial Bancorp having been completed on April 1, 2018 and all necessary regulatory approvals having been received, the transaction is expected to close on May 18, 2018, subject to other customary closing conditions.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The financial condition and results of operations for the Company presented in the Consolidated Financial Statements, accompanying Notes to the Consolidated Financial Statements, and selected financial data appearing elsewhere within this Report, are, to a large degree, dependent upon the Company's accounting policies. The selection of and application of these policies involve estimates, judgments, and uncertainties that are subject to change. The critical accounting policies and estimates that the Company has determined to be the most susceptible to change in the near term relate to the determination of the allowance for loan losses, the valuation of securities available for sale, income tax expense, and the valuation of goodwill and other intangible assets.

Allowance for Loan Losses

The Company maintains an allowance for loan losses to cover probable incurred credit losses at the balance sheet date. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off. A provision for loan losses is charged to operations based on management's periodic evaluation of the necessary allowance balance. Evaluations are conducted at least quarterly and more often if deemed necessary. The ultimate recovery of all loans is susceptible to future market factors beyond the Company's control.

The Company has an established process to determine the adequacy of the allowance for loan losses. The determination of the allowance is inherently subjective, as it requires significant estimates, including the amounts and timing of expected future cash flows on impaired loans, estimated losses on other classified loans and pools of homogeneous loans, and consideration of past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors, all of which may be susceptible to significant change. The allowance consists of two components of allocations, specific and general. These two components represent the total allowance for loan losses deemed adequate to cover losses inherent in the loan portfolio.

Commercial and agricultural loans are subject to a standardized grading process administered by an internal loan review function. The need for specific reserves is considered for credits identified as impaired when: (a) the customer's cash flow or net worth appears insufficient to repay the loan; (b) the loan has been criticized in a regulatory examination; (c) the loan is on non-accrual; or (d) other reasons where the ultimate collectability of the loan is in question, or the loan characteristics require special monitoring. Specific allowances are established in cases where management has identified significant conditions or circumstances related to an individual credit that we believe indicates the loan is impaired.

Specific allocations on impaired loans are determined by comparing the loan balance to the present value of expected cash flows or expected collateral proceeds. Allocations are also applied to categories of loans not considered individually impaired but for which the rate of loss is expected to be greater than historical averages, including non-performing consumer or residential real estate loans. Such allocations are based on past loss experience and information about specific borrower situations and estimated collateral values.

General allocations are made for commercial and agricultural loans that are graded as substandard based on migration analysis techniques to determine historical average losses for similar types of loans. General allocations are also made for other pools of loans, including non-classified loans, homogeneous portfolios of consumer and residential real estate loans, and loans within certain industry categories believed to present unique risk of loss. General allocations of the allowance are primarily made based on historical averages for loan losses for these portfolios, judgmentally

adjusted for economic, external and internal factors and portfolio trends. Economic factors include evaluating changes in international, national, regional and local economic and business conditions that affect the collectability of the loan portfolio. Internal factors include evaluating changes in lending policies and procedures; changes in the nature and volume of the loan portfolio; and changes in experience, ability and depth of lending management and staff. In setting our external and internal factors we also consider the overall level of the allowance for loan losses to total loans; our allowance coverage as compared to similar size bank holding companies; and regulatory requirements.

Due to the imprecise nature of estimating the allowance for loan losses, the Company's allowance for loan losses includes a minor unallocated component. The unallocated component of the allowance for loan losses incorporates the Company's judgmental determination of inherent losses that may not be fully reflected in other allocations, including factors such as economic uncertainties, lending staff quality, industry trends impacting specific portfolio segments, and broad portfolio quality trends. Therefore, the ratio of allocated to unallocated components within the total allowance may fluctuate from period to period.

Securities Valuation

Securities available-for-sale are carried at fair value, with unrealized holding gains and losses reported separately in accumulated other comprehensive income (loss), net of tax. The Company obtains market values from a third party on a monthly basis in order to adjust the securities to fair value. Equity securities that do not have readily determinable fair values are carried at cost, less impairment with observable price changes being recognized in earnings. Additionally, when securities are deemed to be other than temporarily impaired, a charge will be recorded through earnings; therefore, future changes in the fair value of securities could have a significant impact on the Company’s operating results. In determining whether a market value decline is other than temporary, management considers the reason for the decline, the extent of the decline, the duration of the decline and whether the Company intends to sell or believes it will be required to sell the securities prior to recovery. As of March 31, 2018, gross unrealized gains on the securities available-for-sale portfolio totaled approximately $3,969,000 and gross unrealized losses totaled approximately $18,692,000.

Income Tax Expense

Income tax expense involves estimates related to the valuation allowance on deferred tax assets and loss contingencies related to exposure from tax examinations presumed to occur.

A valuation allowance reduces deferred tax assets to the amount management believes is more likely than not to be realized. In evaluating the realization of deferred tax assets, management considers the likelihood that sufficient taxable income of appropriate character will be generated within carry-back and carry-forward periods, including consideration of available tax planning strategies. Tax-related loss contingencies, including assessments arising from tax examinations and tax strategies, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. In considering the likelihood of loss, management considers the nature of the contingency, the progress of any examination or related protest or appeal, the views of legal counsel and other advisors, experience of the Company or other enterprises in similar matters, if any, and management’s intended response to any assessment.

Goodwill and Other Intangible Assets

Goodwill resulting from business combinations represents the excess of the purchase price over the fair value of the net assets of businesses acquired. Goodwill resulting from business combinations is generally determined as the excess of the fair value of the consideration transferred, plus the fair value of any noncontrolling interests in the acquiree, over the fair value of the net assets acquired and liabilities assumed as of the acquisition date. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually. The Company has selected December 31 as the date to perform the annual impairment test. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. Goodwill is the only intangible asset with an indefinite life on the Company’s balance sheet.

Other intangible assets consist of core deposit and acquired customer relationship intangible assets. They are initially measured at fair value and then are amortized over their estimated useful lives, which range from 6 to 10 years.

RESULTS OF OPERATIONS

Net Income:

Net income for the quarter ended March 31, 2018 totaled $11,813,000, or $0.51 per share, an increase of 21% on a per share basis compared with the first quarter 2017 net income of $9,556,000, or $0.42 per share. The first quarter of 2018 net income was positively impacted by lower federal income tax rates that became effective January 1, 2018, as a result of the Tax Act. The lower federal income tax rates had a positive impact of approximately $0.06 per share during the first quarter of 2018.

Net Interest Income:

Net interest income is the Company’s single largest source of earnings, and represents the difference between interest and fees realized on earning assets, less interest paid on deposits and borrowed funds. Several factors contribute to the determination of net interest income and net interest margin, including the volume and mix of earning assets, interest rates, and income taxes. Many factors affecting net interest income are subject to control by management policies and actions. Factors beyond the control of management include the general level of credit and deposit demand, Federal Reserve Board monetary policy, and changes in tax laws.

The following table summarizes net interest income (on a tax-equivalent basis) for the three months ended March 31, 2018 and 2017. For tax-equivalent adjustments, an effective tax rate of 21% was used for the three months ended March 31, 2018 and 35% was used for the three months ended March 31 2017[1].

	Average Balance Sheet (Tax-equivalent basis / dollars in thousands)					
	Three Months Ended March 31, 2018			Three Months Ended March 31, 2017		
	Principal Balance	Income / Expense	Yield / Rate	Principal Balance	Income / Expense	Yield / Rate
ASSETS						
Federal Funds Sold and Other Short-term Investments	$8,556	$56	2.65%	$12,554	$27	0.88%
Securities:						
Taxable	480,999	2,998	2.49%	479,875	2,719	2.27%
Non-taxable	272,590	2,710	3.98%	251,996	3,115	4.94%
Total Loans and Leases[2]	2,139,704	24,032	4.55%	1,974,846	22,440	4.60%
TOTAL INTEREST EARNING ASSETS	2,901,849	29,796	4.15%	2,719,271	28,301	4.20%
Other Assets	234,998			221,829		
Less: Allowance for Loan Losses	(15,876)			(15,005)		
TOTAL ASSETS	$3,120,971			$2,926,095		
LIABILITIES AND SHAREHOLDERS' EQUITY						
Interest-bearing Demand, Savings and Money Market Deposits	$1,489,363	$1,275	0.35%	$1,385,347	$738	0.22%
Time Deposits	398,397	1,008	1.03%	401,155	705	0.71%
FHLB Advances and Other Borrowings	262,784	1,252	1.93%	226,786	865	1.55%
TOTAL INTEREST-BEARING LIABILITIES	2,150,544	3,535	0.67%	2,013,288	2,308	0.47%
Demand Deposit Accounts	585,432			557,912		
Other Liabilities	21,416			19,309		
TOTAL LIABILITIES	2,757,392			2,590,509		
Shareholders' Equity	363,579			335,586		
TOTAL LIBABILITIES AND SHAREHOLDERS' EQUITY	$3,120,971			$2,926,095		
COST OF FUNDS			0.49%			0.34%
NET INTEREST INCOME		$26,261			$25,993	
NET INTEREST MARGIN			3.66%			3.86%

(1) Effective tax rates were determined as though interest earned on the Company's investments in municipal bonds and loans was fully taxable.

(2) Loans held-for-sale and non-accruing loans have been included in average loans.

Net interest income increased $885,000, or 4%, for the quarter ended March 31, 2018 compared with the same quarter of 2017. The net interest margin represents tax-equivalent net interest income expressed as a percentage of average earning assets. The tax equivalent net interest margin was 3.66% for the first quarter of 2018 compared to 3.86% during the first quarter of 2017. The tax equivalent yield on earning assets totaled 4.15% during the quarter ended March 31, 2018 compared to 4.20% in the same period of 2017, while the cost of funds (expressed as a percentage of average earning assets) totaled 0.49% during the quarter ended March 31, 2018 compared to 0.34% in the same period of 2017.

The increased level of net interest income during the first quarter of 2018 compared with the first quarter of 2017 was driven by an increased level of average earning assets and more specifically average loans outstanding, which was partially offset by a higher cost of funds. Average loans outstanding increased during the first quarter of 2018 by approximately $164.9 million, or 8%, as compared to the first quarter of 2017.

The decline in the net interest margin during the first quarter of 2018 was primarily attributable to a decrease in the amount of accretion of loan discounts on acquired loans, an increase in the cost of funds, and the decline in the federal income tax rates in 2018 compared with 2017. Accretion of loan discounts on acquired loans contributed approximately 4 basis points to the net interest margin on an annualized basis in the first quarter of 2018 compared with 17 basis points in the first quarter of 2017. The Company's cost of funds increased approximately 15 basis points in the first quarter of 2018 compared with the first quarter of 2017. The higher cost of funds was largely attributable to an increase in short-term market interest rates over the past several

quarters. The lower federal income tax rates during the first quarter of 2018 had an approximately 9 basis point negative impact on the Company's net interest margin and earning asset yield.

Provision for Loan Losses:

The Company provides for loan losses through regular provisions to the allowance for loan losses. The provision is affected by net charge-offs on loans and changes in specific and general allocations of the allowance. During the quarter ended March 31, 2018, the provision for loan losses totaled $350,000 compared with a $500,000 provision for loan losses during the first quarter of 2017. The provision for loan losses represented approximately 7 basis points and 10 basis points of average loans on an annualized basis in the first quarter of 2018 and 2017, respectively.

Net charge-offs totaled $1,584,000 or 30 basis points on an annualized basis of average loans outstanding during the three months ended March 31, 2018, compared with $143,000 or 3 basis points on an annualized basis of average loans outstanding during the same period of 2017. The increase in net charge-offs during the first quarter of 2018 was primarily attributable to a partial charge-off on a single commercial lending relationship that was downgraded during the fourth quarter of 2017.

The provision for loan losses made during the three months ended March 31, 2018 was made at a level deemed necessary by management to absorb changes in estimated, probable incurred losses in the loan portfolio. A detailed evaluation of the adequacy of the allowance for loan losses is completed quarterly by management, the results of which are used to determine provision for loan losses. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors.

Non-interest Income:

During the quarter ended March 31, 2018, non-interest income totaled $9,492,000, an increase of $1,304,000, or 16%, compared with the first quarter of 2017.

Non-interest Income (dollars in thousands)	Three Months Ended March 31,		Change From Prior Period	
	2018	2017	Amount Change	Percent Change
Trust and Investment Product Fees	$1,773	$1,243	$530	43 %
Service Charges on Deposit Accounts	1,471	1,484	(13)	(1)
Insurance Revenues	2,930	2,640	290	11
Company Owned Life Insurance	312	254	58	23
Interchange Fee Income	1,482	1,023	459	45
Other Operating Income	604	857	(253)	(30)
Subtotal	8,572	7,501	1,071	14
Net Gains on Sales of Loans	650	687	(37)	(5)
Net Gains on Securities	270	—	270	n/m[(1)]
Total Non-interest Income	$9,492	$8,188	$1,304	16

(1) n/m=not meaningful

Trust and investment product fees increased $530,000, or 43%, during the first quarter of 2018 compared with the first quarter of 2017. Increased assets under management in the Company's wealth advisory group contributed to this

increase in trust and investment product fees.

Insurance revenues increased $290,000, or 11%, during the quarter ended March 31, 2018, compared with the first quarter of 2017. The increase during the first quarter of 2018 compared with the first quarter of 2017 was primarily due to increased contingency revenue. Contingency revenue during the first quarter of 2018 totaled $1,218,000 compared with $992,000 during the first quarter of 2017. The fluctuation in contingency revenue is a normal course of business variance and is reflective of claims and loss experience with insurance carriers that the Company represents through its property and casualty insurance agency. Typically, the majority of contingency revenue is recognized during the first quarter of the year.

Interchange fees increased $459,000, or 45%, during the first quarter of 2018 compared with the first quarter of 2017. The increase during the first quarter of 2018 was largely attributable to the adoption of the new revenue recognition standard effective January 1, 2018. While the adoption of the standard did not have a significant impact on the Company's financial results, the recording

of revenue gross versus net of certain expenses, in accordance with the standard, did result in the reclassification of some expenses associated with the interchange fee revenue during the first quarter of 2018.

Other operating income decreased $254,000, or 30%, during the quarter ended March 31, 2018 compared with the first quarter of 2017. The decline was largely attributable to decreased fees associated with swap transactions with loan customers.

The Company realized a net gain on sales of securities of $270,000 during the first quarter of 2018 related to the sale of $5.9 million of securities compared to no gain on the sale of securities in the first quarter of 2017.

Non-interest Expense:

During the quarter ended March 31, 2018, non-interest expense totaled $20,455,000, an increase of $1,419,000, or 7%, compared with the first quarter of 2017.

Non-interest Expense (dollars in thousands)	Three Months Ended March 31,		Change From Prior Period	
	2018	2017	Amount Change	Percent Change
Salaries and Employee Benefits	$12,126	$11,444	$682	6 %
Occupancy, Furniture and Equipment Expense	2,409	2,182	227	10
FDIC Premiums	237	239	(2)	(1)
Data Processing Fees	1,127	1,011	116	11
Professional Fees	871	803	68	8
Advertising and Promotion	701	778	(77)	(10)
Intangible Amortization	206	253	(47)	(19)
Other Operating Expenses	2,778	2,326	452	19
Total Non-interest Expense	$20,455	$19,036	$1,419	7

Salaries and benefits increased $682,000, or 6%, during the quarter ended March 31, 2018 compared with the first quarter of 2017. The increase in salaries and benefits during the first quarter of 2018 compared with the first quarter of 2017 was primarily attributable to an increased number of full-time equivalent employees.

Occupancy, furniture, and equipment expense increased $227,000, or 10%, during the quarter ended March 31, 2018 compared with the first quarter of 2017. The increase was largely related to various repairs and maintenance expenses including snow removal during the first quarter of 2018.

Other operating expenses increased $452,000, or 19%, during the first quarter of 2018 compared with the first quarter of 2017. The increase in the first quarter of 2018 was largely attributable to the adoption of the aforementioned revenue recognition standard effective January 1, 2018.

Income Taxes:

The Company's effective income tax rate was 17.4% and 28.6%, respectively, during the three months ended March 31, 2018 and 2017. The effective tax rate in all periods presented was lower than the blended statutory rate resulting primarily from the Company's tax-exempt investment income on securities, loans and company-owned life insurance, income tax credits generated from affordable housing projects, and income generated by subsidiaries domiciled in a state with no state or local income tax.

During the quarter ended March 31, 2018, the Company recorded a provision for income tax expense of $2,484,000 compared with a provision for income tax expense of $3,821,000 in the first quarter of 2017. The provision for income tax and the effective tax rate was positively impacted during the first quarter of 2018 by the reduction of federal income tax rates from a statutory rate of 35% to 21% effective January 1, 2018 related to the federal tax reform legislation enacted during the fourth quarter of 2017.

FINANCIAL CONDITION

Total assets for the Company decreased to $3.125 billion at March 31, 2018, representing a decline of $19.3 million, or 2% on an annualized basis, compared with December 31, 2017.

At March 31, 2018, total loans increased $8.8 million, or 2% on an annualized basis, compared with December 31, 2017. The

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increase during the first quarter of 2018 was driven by an increase of approximately $21.2 million, or 9% on an annualized basis, of commercial real estate loans, partially mitigated by a decline of of $4.4 million, or 4% on an annualized basis, of commercial and industrial loans, a seasonal decline of $4.1 million, or 5% on an annualized basis, of agricultural loans and a decline of $3.9 million, or 4% on annualized basis, of retail loans which include home equity, consumer and residential loans.

End of Period Loan Balances: (dollars in thousands)	March 31, 2018	December 31, 2017	Current Period Change
Commercial and Industrial Loans and Leases	$482,219	$486,668	$(4,449)
Commercial Real Estate Loans	947,948	926,729	21,219
Agricultural Loans	329,138	333,227	(4,089)
Home Equity and Consumer Loans	216,435	219,662	(3,227)
Residential Mortgage Loans	178,108	178,733	(625)
Total Loans	$2,153,848	$2,145,019	$8,829

The following table indicates the breakdown of the allowance for loan losses for the periods indicated (dollars in thousands):

	March 31, 2018	December 31, 2017
Commercial and Industrial Loans and Leases	$3,603	$ 4,735
Commercial Real Estate Loans	4,622	4,591
Agricultural Loans	4,825	4,894
Home Equity and Consumer Loans	588	628
Residential Mortgage Loans	327	343
Unallocated	495	503
Total Allowance for Loan Loss	$14,460	$ 15,694

The Company's allowance for loan losses totaled $14.5 million at March 31, 2018 compared to $15.7 million at December 31, 2017. The allowance for loan losses represented 0.67% of period-end loans at March 31, 2018 compared with 0.73% of period-end loans at December 31, 2017. The decline in the allowance for loan losses during the first quarter of 2018 was largely related to a partial charge-off on a single commercial lending relationship down-graded during the fourth quarter of 2017. Under acquisition accounting treatment, loans acquired are recorded at fair value which includes a credit risk component, and therefore the allowance on loans acquired is not carried over from the seller. The Company held a net discount on acquired loans of $7.3 million as of March 31, 2018 and $7.6 million at December 31, 2017.

The following is an analysis of the Company's non-performing assets at March 31, 2018 and December 31, 2017:

Non-performing Assets: (dollars in thousands)	March 31, 2018	December 31, 2017
Non-accrual Loans	$9,479	$11,091
Past Due Loans (90 days or more)	1,105	719
Total Non-performing Loans	10,584	11,810
Other Real Estate	68	54
Total Non-performing Assets	$10,652	$11,864

Restructured Loans	$124		$149	
Non-performing Loans to Total Loans	0.49	%	0.55	%
Allowance for Loan Loss to Non-performing Loans	136.62	%	132.89	%

The following tables present non-accrual loans and loans past due 90 days or more still on accrual by class of loans:

	Non-Accrual Loans		Loans Past Due 90 Days or More & Still Accruing	
	March 31, 2018	December 31, 2017	March 31, 2018	December 31, 2017
Commercial and Industrial Loans and Leases	$3,105	$ 4,753	$ —	$ —
Commercial Real Estate Loans	4,502	4,618	884	471
Agricultural Loans	697	748	221	248
Home Equity Loans	188	199	—	—
Consumer Loans	71	286	—	—
Residential Mortgage Loans	916	487	—	—
Total	$9,479	$ 11,091	$ 1,105	$ 719

Non-performing assets totaled $10.7 million at March 31, 2018 compared to $11.9 million of non-performing assets at December 31, 2017. Non-performing assets represented 0.34% of total assets at March 31, 2018 compared to 0.38% of total assets at December 31, 2017. Non-performing loans totaled $10.6 million at March 31, 2018 compared to $11.8 million at December 31, 2017. Non-performing loans represented 0.49% of total loans at March 31, 2018 compared to 0.55% at December 31, 2017. The decline in non-performing assets during the first quarter of 2018 was primarily attributable to a partial charge-off on a single commercial lending relationship that was downgraded during the fourth quarter of 2017.

Loan impairment is reported when repayment under the terms of the loan is not expected. If a loan is impaired, a portion of the allowance is specifically allocated so that the loan is reported net, at the present value of estimated future cash flows using the loan’s existing rate, or at the fair value of collateral if repayment is expected solely from the collateral. Commercial and industrial loans, commercial real estate loans, and agricultural loans are evaluated individually for impairment. Smaller balance homogeneous loans are evaluated for impairment in total. Such loans include real estate loans secured by one-to-four family residences and loans to individuals for household, family and other personal expenditures. Individually evaluated loans on non-accrual are generally considered impaired. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

Total deposits declined $16.9 million, or 3% on an annualized basis, as of March 31, 2018 compared with December 31, 2017.

End of Period Deposit Balances: (dollars in thousands)	March 31, 2018	December 31, 2017	Current Period Change
Non-interest-bearing Demand Deposits	$599,374	$606,134	$(6,760)
Interest-bearing Demand, Savings, & Money Market Accounts	1,465,150	1,490,033	(24,883)
Time Deposits < $100,000	193,864	198,646	(4,782)
Time Deposits of $100,000 or more	208,733	189,239	19,494
Total Deposits	$2,467,121	$2,484,052	$(16,931)

Capital Resources:

As of March 31, 2018, shareholders’ equity declined by $566,000 to $364.0 million compared with $364.6 million at year-end 2017. The decline in shareholders' equity was primarily attributable to a decline of $9.2 million in

accumulated other comprehensive income primarily related to the decrease in value of the Company's available-for-sale securities portfolio, which was partially offset by an increase in retained earnings of $8.4 million. Shareholders' equity represented 11.6% of total assets at March 31, 2018 and 11.6% of total assets at December 31, 2017. Shareholders' equity included $56.0 million of goodwill and other intangible assets at March 31, 2018 compared to $56.2 million of goodwill and other intangible assets at December 31, 2017.

Federal banking regulations provide guidelines for determining the capital adequacy of bank holding companies and banks. These guidelines provide for a more narrow definition of core capital and assign a measure of risk to the various categories of assets. The Company is required to maintain minimum levels of capital in proportion to total risk-weighted assets and off-balance sheet exposures.

As of January 1, 2015, the Company and its subsidiary bank adopted the new Basel III regulatory capital framework. The adoption of this new framework modified the regulatory capital calculations, minimum capital levels and well-capitalized thresholds and added the new Common Equity Tier 1 capital ratio. Additionally, under the new rules, in order to avoid limitations on capital distributions, including dividend payments, the Company is required to maintain a capital conservation buffer above the adequately capitalized regulatory capital ratios. The capital conservation buffer is being phased in from 0.00% in 2015 to 2.50% in 2019. For March 31, 2018, the capital conservation buffer was 1.875% and for December 31, 2017, the capital conservation buffer was 1.25%. At March 31, 2018, the capital levels for the Company and its subsidiary bank remained well in excess of of the minimum amounts needed for capital adequacy purposes and the bank's capital levels met the necessary requirements to be considered well-capitalized.

The table below presents the Company’s consolidated and the subsidiary bank's capital ratios under regulatory guidelines:

	3/31/2018 Ratio		12/31/2017 Ratio		Minimum for Capital Adequacy Purposes		Well-Capitalized Guidelines	
Total Capital (to Risk Weighted Assets)								
Consolidated	13.83	%	13.62	%	8.00	%	N/A	
Bank	12.34	%	12.29	%	8.00	%	10.00	%
Tier 1 (Core) Capital (to Risk Weighted Assets)								
Consolidated	13.25	%	12.99	%	6.00	%	N/A	
Bank	11.77	%	11.66	%	6.00	%	8.00	%
Common Tier 1, (CET 1) Capital Ratio (to Risk Weighted Assets)								
Consolidated	12.81	%	12.55	%	4.50	%	N/A	
Bank	11.77	%	11.66	%	4.50	%	6.50	%
Tier 1 Capital (to Average Assets)								
Consolidated	10.81	%	10.71	%	4.00	%	N/A	
Bank	9.62	%	9.63	%	4.00	%	5.00	%

Under the the final rules provided for by Basel III, accumulated other comprehensive income ("AOCI") was to be included in a banking organization's Common Equity Tier 1 capital. The final rules allowed community banks to make a one-time election not to include the additional components of AOCI in regulatory capital and instead use the existing treatment under the general risk-based capital rules that excludes most AOCI components from regulatory capital. The Company elected, in its March 31, 2015 regulatory filings (Call Report and FR Y-9), to opt-out and continue the existing treatment of AOCI for regulatory capital purposes.

Liquidity:

The Consolidated Statement of Cash Flows details the elements of changes in the Company’s consolidated cash and cash equivalents. Total cash and cash equivalents decreased $30.1 million during the three months March 31, 2018 ending at $40.2 million. During the three months ended March 31, 2018, operating activities resulted in net cash inflows of $13.7 million. Investing activities resulted in net cash outflows of $22.8 million during the three months ended March 31, 2018. Financing activities resulted in net cash outflows for the three months ended March 31, 2018 of $21.1 million.

The parent company is a corporation separate and distinct from its bank and other subsidiaries. The Company uses funds at the parent-company level to pay dividends to its shareholders, to acquire or make other investments in other

businesses or their securities or assets, to repurchase its stock from time to time, and for other general corporate purposes including debt service. The parent company does not have access at the parent-company level to the deposits and certain other sources of funds that are available to its bank subsidiary to support its operations. Instead, the parent company has historically derived most of its revenues from dividends paid to the parent company by its bank subsidiary. The Company's banking subsidiary is subject to statutory restrictions on its ability to pay dividends to the parent company. The parent company has in recent years supplemented the dividends received from its subsidiaries with borrowings. As of March 31, 2018, the parent company had approximately $27.9 million of cash and cash equivalents available to meet its cash flow needs.

FORWARD-LOOKING STATEMENTS AND ASSOCIATED RISKS

The Company from time to time in its oral and written communications makes statements relating to its expectations regarding the future. These types of statements are considered “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. The Company may include forward-looking statements in filings with the Securities and Exchange Commission (“SEC”), such as this Form 10-Q, in other written materials, and in oral statements made by senior management to analysts, investors, representatives of the media, and others. Such forward looking statements can include statements about the Company’s net interest income or net interest margin; its adequacy of allowance for loan losses, levels of provisions for loan losses, and the quality of the Company’s loans, investment securities and other assets; simulations of changes in interest rates; expected results from mergers with or acquisitions of other businesses; litigation results; tax estimates and recognition; dividend policy; parent company cash resources and cash requirements, and parent company capital resources; estimated cost savings, plans and objectives for future operations; and expectations about the Company’s financial and business performance and other business matters as well as economic and market conditions and trends. They often can be identified by the use of words like “plan,” “expect,” “can,” “might,” “may,” “will,” “would,” “could,” “should,” “intend,” “project,” “estimate,” “believe” or “anticipate,” or simila

Forward-looking statements speak only as of the date they are made, and the Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the forward-looking statement is made.

Readers are cautioned that, by their nature, all forward-looking statements are based on assumptions and are subject to risks, uncertainties, and other factors. Actual results may differ materially and adversely from the expectations of the Company that are expressed or implied by any forward-looking statement. The discussions in this Item 2 list some of the factors that could cause the Company’s actual results to vary materially from those expressed or implied by any forward-looking statements. Other risks, uncertainties, and factors that could cause the Company’s actual results to vary materially from those expressed or implied by any forward-looking statement include the unknown future direction of interest rates and the timing and magnitude of any changes in interest rates; changes in competitive conditions; the introduction, withdrawal, success and timing of asset/liability management strategies or of mergers and acquisitions and other business initiatives and strategies; changes in customer borrowing, repayment, investment and deposit practices; changes in fiscal, monetary and tax policies; changes in financial and capital markets; deterioration in general economic conditions, either nationally or locally, resulting in, among other things, credit quality deterioration; capital management activities, including possible future sales of new securities, or possible repurchases or redemptions by the Company of outstanding debt or equity securities; risks of expansion through acquisitions and mergers, such as unexpected credit quality problems of the acquired loans or other assets, unexpected attrition of the customer base of the acquired institution or branches, and difficulties in integration of the acquired operations; factors driving impairment charges on investments; the impact, extent and timing of technological changes; potential cyber-attacks, information security breaches and other criminal activities; litigation liabilities, including related costs, expenses, settlements and judgments, or the outcome of matters before regulatory agencies, whether pending or commencing in the future; actions of the Federal Reserve Board; changes in accounting principles and interpretations; the expected impact of U.S. tax regulations passed in December 2017; potential increases of federal deposit insurance premium expense, and possible future special assessments of FDIC premiums, either industry wide or specific to the Company’s banking subsidiary; actions of the regulatory authorities under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and the Federal Deposit Insurance Act and other possible legislative and regulatory actions and reforms; impacts resulting from possible amendments or revisions to the Dodd-Frank Act and the regulations promulgated thereunder, or to Consumer Financial Protection Bureau rules and regulations; and the continued availability of earnings and excess capital sufficient for the lawful and prudent declaration and payment of cash dividends. Such statements reflect our views with respect to future events and are subject to these and other risks, uncertainties and assumptions relating to the operations, results of operations, growth strategy and liquidity of the Company. Readers are cautioned not to place undue reliance on these forward-looking statements.

Investors should consider these risks, uncertainties, and other factors, in addition to those mentioned by the Company in its Annual Report on Form 10-K for its fiscal year ended December 31, 2017, and other SEC filings from time to time, when considering any forward-looking statement.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company's exposure to market risk is reviewed on a regular basis by the Asset/Liability Committee and Boards of Directors of the parent company and its subsidiary bank. Primary market risks which impact the Company's operations are liquidity risk and interest rate risk.

The liquidity of the parent company is dependent upon the receipt of dividends from its subsidiary bank, which is subject to certain regulatory limitations. The Bank's source of funding is predominately core deposits, maturities of securities, repayments of loan principal and interest, federal funds purchased, securities sold under agreements to repurchase and borrowings from the Federal Home Loan Bank.

The Company monitors interest rate risk by the use of computer simulation modeling to estimate the potential impact on its net interest income under various interest rate scenarios, and by estimating its static interest rate sensitivity position. Another method by which the Company's interest rate risk position can be estimated is by computing estimated changes in its net portfolio value ("NPV"). This method estimates interest rate risk exposure from movements in interest rates by using interest rate sensitivity analysis to determine the change in the NPV of discounted cash flows from assets and liabilities. NPV represents the market value of portfolio equity and is equal to the estimated market value of assets minus the estimated market value of liabilities.

Computations for measuring both net interest income and NPV are based on a number of assumptions, including the relative levels of market interest rates and prepayments in mortgage loans and certain types of investments. These computations do not contemplate any actions management may undertake in response to changes in interest rates, and should not be relied upon as indicative of actual results. In addition, certain shortcomings are inherent in the method of computing both net interest income and NPV. Should interest rates remain or decrease below current levels, the proportion of adjustable rate loans could decrease in future periods due to refinancing activity. In the event of an interest rate change, prepayment levels would likely be different from those assumed in the modeling. Lastly, the ability of many borrowers to repay their adjustable rate debt may decline during a rising interest rate environment.

The Company from time to time utilizes derivatives to manage interest rate risk. Management continuously evaluates the merits of such interest rate risk products but does not anticipate the use of such products to become a major part of the Company's risk management strategy.

The table below provides an assessment of the risk to net interest income over the next 12 months in the event of a sudden and sustained 1% and 2% increase and decrease in prevailing interest rates (dollars in thousands).

Interest Rate Sensitivity as of March 31, 2018 - Net Interest Income

	Net Interest Income	
Changes in Rates	Amount	% Change
+2%	$105,155	(2.37)%
+1%	106,465	(1.16)%
Base	107,711	—
-1%	103,514	(3.90)%
-2%	95,808	(11.05)%

The above table is a measurement of the Company's net interest income at risk, assuming a static balance sheet as of March 31, 2018 and instantaneous parallel changes in interest rates. The Company also monitors interest rate risk under other scenarios including a more gradual movement in market interest rates. This type of scenario can at times produce different modeling results in measuring interest rate risk sensitivity.

The table below provides an assessment of the risk to NPV in the event of a sudden and sustained 1% and 2% increase and decrease in prevailing interest rates (dollars in thousands).

Interest Rate Sensitivity as of March 31, 2018 - Net Portfolio Value

	Net Portfolio Value		Net Portfolio Value as a % of Present Value of Assets	
Changes in Rates	Amount	% Change	NPV Ratio	Change
+2%	$441,178	(8.26)%	15.12%	(54) b.p.
+1%	463,198	(3.69)%	15.46%	(20) b.p.
Base	480,921	—	15.66%	—
-1%	466,968	(2.90)%	14.90%	(76) b.p.
-2%	425,103	(11.61)%	13.33%	(233) b.p.

This Item 3 includes forward-looking statements. See “Forward-looking Statements and Associated Risks” included in Part I, Item 2 of this Report for a discussion of certain factors that could cause the Company’s actual exposure to market risk to vary materially from that expressed or implied above. These factors include possible changes in economic conditions; interest rate fluctuations, competitive product and pricing pressures within the Company’s markets; and equity and fixed income market fluctuations. Actual experience may also vary materially to the extent that the Company’s assumptions described above prove to be inaccurate.

Item 4. Controls and Procedures

As of March 31, 2018, the Company carried out an evaluation, under the supervision and with the participation of its principal executive officer and principal financial officer, of the effectiveness of the design and operation of its disclosure controls and procedures. Based on this evaluation, the Company’s principal executive officer and principal financial officer concluded that the Company’s disclosure controls and procedures were, as of that date, effective in timely alerting them to material information required to be included in the Company’s periodic reports filed with the Securities and Exchange Commission. There are inherent limitations to the effectiveness of systems of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective systems of disclosure controls and procedures can provide only reasonable assurances of achieving their control objectives.

There was no change in the Company’s internal control over financial reporting that occurred during the Company’s first fiscal quarter of 2018 that has materially affected, or is reasonably likely to materially affect, the Company’s internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

There are no pending legal proceedings, other than litigation incidental to the ordinary business of the Company, of a material nature to which the Company is a party or of which any of its properties are subject.

Item 1A. Risk Factors

There have been no material changes to the risk factors previously disclosed in German American Bancorp, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2017.

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

Issuer Purchases of Equity Securities
The following table sets forth information regarding the Company’s purchases of its common shares during each of the three months ended March 31, 2018.

Period	Total Number of Shares (or Units) Purchased	Average Price Paid Per Share (or Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased under the Plans or Programs [1]
January 2018	—	—	—	409,184
February 2018	—	—	—	409,184
March 2018	—	—	—	409,184

[1] On April 26, 2001, the Company announced that its Board of Directors had approved a stock repurchase program for up to 911,631 of its outstanding common shares, of which the Company had purchased 502,447 common shares through March 31, 2018 (both such numbers adjusted for subsequent stock dividends). The Board of Directors established no expiration date for this program. The Company purchased no shares under this program during the quarter ended March 31, 2018.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

The following exhibits are included with this Report or incorporated herein by reference.

Exhibit No.	Description
2.1	Purchase and Assumption Agreement by and between German American Bancorp and MainSource Bank, dated February 12, 2018, is incorporated by reference to Exhibit 2.1 of the Registrant's Current Report on Form 8-K filed February 13, 2018 (SEC File No. 001-15877).
3.1	Restatement of the Articles of Incorporation of German American Bancorp, Inc., as amended, is incorporated by reference to Exhibit 3.1 of the Registrant’s Quarterly Report on Form 10-Q for the quarter ended March 31, 2017 filed on May 9, 2017 (SEC File No. 001-15877).
3.2	Restated Bylaws of German American Bancorp, Inc., as amended and restated July 27, 2009, is incorporated by reference to Exhibit 3.2 of the Registrant's Annual Report on Form 10-K filed March 9, 2015 (SEC File No. 001-15877).
4.1	Terms of Common Shares and Preferred Shares of the Registrant (included in Restatement of Articles of Incorporation) are incorporated by reference to Exhibit 3.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2017 filed on May 9, 2017 (SEC File No. 001-15877).
4.2	Specimen stock certificate for Common Shares of the Registrant is incorporated by reference to Exhibit 99.1 to the Registrant's Current Report on Form 8-K filed October 21, 2010 (SEC File No. 001-15877).
31.1*	Sarbanes-Oxley Act of 2002, Section 302 Certification for Chairman of the Board and Chief Executive Officer.
31.2*	Sarbanes-Oxley Act of 2002, Section 302 Certification for Executive Vice President and Chief Financial Officer.
32.1*	Sarbanes-Oxley Act of 2002, Section 906 Certification for Chairman of the Board and Chief Executive Officer.
32.2*	Sarbanes-Oxley Act of 2002, Section 906 Certification for Executive Vice President and Chief Financial Officer.
101+	The following materials from German American Bancorp, Inc.’s Form 10-Q Report for the quarterly period ended March 31, 2018, formatted in XBRL: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Cash Flows, and (v) the Notes to Consolidated Financial Statements.

Note: No long-term debt instrument issued by the Registrant exceeds 10% of consolidated total assets or is registered. In accordance with paragraph 4 (iii) of Item 601(b) of Regulation S-K, the Registrant will furnish the Securities and Exchange Commission copies of long-term debt instruments and related agreements upon request.

*Exhibits that are filed with this Report (other than through incorporation by reference to other disclosures or exhibits) are indicated by a double asterisk.

+Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are furnished and not deemed filed or part of a registration statement or prospectus for purposes of Sections 11 and 12 of the Securities Act of 1933, as amended, and are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

SIGNATURES

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

GERMAN AMERICAN BANCORP, INC.

Date: May 9, 2018 By: /s/Mark A. Schroeder
Mark A. Schroeder
Chairman and Chief Executive Officer
(Principal Executive Officer)

Date: May 9, 2018 By: /s/Bradley M. Rust
Bradley M. Rust
Executive Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)