

AVATAR HOLDINGS INC
Form 10-Q
August 09, 2006

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

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended June 30, 2006**

or

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____**

**Commission file number 0-7616
I.R.S. Employer Identification Number 23-1739078**

Avatar Holdings Inc.
(a Delaware Corporation)
201 Alhambra Circle
Coral Gables, Florida 33134
(305) 442-7000

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 8,193,736 shares of Avatar's common stock (\$1.00 par value) were outstanding as of July 31, 2006.

AVATAR HOLDINGS INC. AND SUBSIDIARIES
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Table of Contents**PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****AVATAR HOLDINGS INC. AND SUBSIDIARIES**Consolidated Balance Sheets
(Dollars in thousands)

| | (Unaudited) | |
|---|-------------------|------------------------|
| | June 30 2006 | December 31 2005 |
| Assets | | |
| Cash and cash equivalents | \$ 63,218 | \$ 38,479 |
| Restricted cash | 7,775 | 6,020 |
| Receivables, net | 22,051 | 29,865 |
| Land and other inventories | 470,130 | 392,843 |
| Land inventory not owned | | 18,171 |
| Property, plant and equipment, net | 41,475 | 41,444 |
| Investment in unconsolidated joint ventures | 9,080 | 55,781 |
| Prepaid expenses | 11,243 | 13,985 |
| Other assets | 8,564 | 9,110 |
| Deferred income taxes | 8,452 | 3,823 |
| Assets of business transferred under contractual arrangements | | 16,889 |
| Total Assets | \$ 641,988 | \$ 626,410 |
| | | |
| Liabilities and Stockholders' Equity | | |
| Liabilities | | |
| Notes, mortgage notes and other debt: | | |
| Corporate | \$ 120,000 | \$ 120,000 |
| Real estate | 18,425 | 24,107 |
| Obligations related to land inventory not owned | | 18,171 |
| Estimated development liability for sold land | 26,404 | 26,717 |
| Accounts payable | 19,472 | 16,526 |
| Accrued and other liabilities | 27,076 | 42,087 |
| Customer deposits | 60,125 | 57,797 |
| Liabilities of business transferred under contractual arrangements | | 8,113 |
| Total Liabilities | 271,502 | 313,518 |
| | | |
| Commitments and Contingencies | | |
| | | |
| Stockholders' Equity | | |
| Common Stock, par value \$1 per share | | |
| Authorized: 50,000,000 shares | | |
| Issued: 10,725,559 shares at June 30, 2006 10,711,286 shares at December 31, 2005 | 10,726 | 10,711 |
| Additional paid-in capital | 214,050 | 214,873 |

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| | | |
|--|------------|------------|
| Unearned restricted stock units | | (6,583) |
| Retained earnings | 220,734 | 168,915 |
| | 445,510 | 387,916 |
| Treasury stock: at cost, 2,531,823 shares at June 30, 2006 and December 31, 2005 | (75,024) | (75,024) |
| Total Stockholders' Equity | 370,486 | 312,892 |
| Total Liabilities and Stockholders' Equity | \$ 641,988 | \$ 626,410 |

See notes to consolidated financial statements.

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AVATAR HOLDINGS INC. AND SUBSIDIARIES
Consolidated Statements of Income
For the six and three months ended June 30, 2006 and 2005
(Unaudited)
(Dollars in thousands except per-share amounts)

| | Six Months | | Three Months | |
|--|------------------|------------------|------------------|-----------------|
| | 2006 | 2005 | 2006 | 2005 |
| Revenues | | | | |
| Real estate sales | \$ 323,182 | \$ 196,930 | \$ 168,876 | \$ 106,411 |
| Interest income | 1,517 | 682 | 880 | 328 |
| Other | 1,204 | 1,030 | 933 | 680 |
| Total revenues | 325,903 | 198,642 | 170,689 | 107,419 |
| Expenses | | | | |
| Real estate expenses | 234,417 | 163,749 | 119,355 | 90,925 |
| General and administrative expenses | 13,771 | 12,244 | 7,199 | 6,234 |
| Interest expense | | 461 | | |
| Other | 17 | 34 | 17 | 13 |
| Total expenses | 248,205 | 176,488 | 126,571 | 97,172 |
| Equity earnings from unconsolidated joint ventures | 1,720 | 12,324 | 90 | 4,755 |
| Income from continuing operations before income taxes | 79,418 | 34,478 | 44,208 | 15,002 |
| Income tax expense | (27,599) | (10,229) | (17,025) | (4,762) |
| Income from continuing operations | 51,819 | 24,249 | 27,183 | 10,240 |
| Discontinued operations: | | | | |
| Loss from operations of discontinued operations including loss on disposal of \$1,683 for the six and three months ended in 2005 | | (1,113) | | (1,372) |
| Income tax benefit | | 423 | | 521 |
| Loss from discontinued operations | | (690) | | (851) |
| Net income | \$ 51,819 | \$ 23,559 | \$ 27,183 | \$ 9,389 |
| Basic Earnings Per Share: | | | | |
| Income from continuing operations | \$ 6.33 | \$ 3.01 | \$ 3.32 | \$ 1.27 |
| Loss from discontinued operations | | (0.09) | | (0.10) |
| Net income | \$ 6.33 | \$ 2.92 | \$ 3.32 | \$ 1.17 |

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Diluted Earnings Per Share:

| | | | | |
|-----------------------------------|---------|---------|---------|---------|
| Income from continuing operations | \$ 5.01 | \$ 2.45 | \$ 2.62 | \$ 1.04 |
| Loss from discontinued operations | | (0.06) | | (0.08) |
| Net income | \$ 5.01 | \$ 2.39 | \$ 2.62 | \$ 0.96 |

See notes to consolidated financial statements.

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Consolidated Statements of Cash Flows (Unaudited)

For the six months ended June 30, 2006 and 2005

(Dollars in Thousands)

| | 2006 | 2005 |
|---|----------------|-----------------|
| OPERATING ACTIVITIES | | |
| Net income | \$ 51,819 | \$ 23,559 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 2,083 | 2,446 |
| Amortization of stock-based compensation | 5,318 | 1,465 |
| Impairment of goodwill | 654 | |
| Distributions of earnings from an unconsolidated joint venture | 29,132 | 1,695 |
| Equity earnings from unconsolidated joint ventures | (1,720) | (12,324) |
| Deferred income taxes | (4,423) | (1,391) |
| Excess income tax benefit from exercise of stock options | (140) | |
| Changes in operating assets and liabilities: | | |
| Restricted cash | (1,755) | (5,793) |
| Receivables, net | 2,904 | (6,908) |
| Land and other inventories | (80,075) | (67,301) |
| Prepaid expenses | 2,742 | 539 |
| Other assets | (107) | 7,101 |
| Accounts payable and accrued and other liabilities | (10,968) | (6,131) |
| Customer deposits | 2,328 | 15,868 |
| Assets/liabilities of business transferred under contractual arrangements | 8,776 | (744) |
| Assets/liabilities of discontinued operations | | 1,672 |
| NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES | 6,568 | (46,247) |
| INVESTING ACTIVITIES | | |
| Investment in property, plant and equipment | (736) | (825) |
| Investment in unconsolidated joint ventures | (417) | (888) |
| Return of advances from promissory note | 4,910 | |
| Distributions of capital from an unconsolidated joint venture | 19,706 | |
| Advances under promissory note | | (510) |
| NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES | 23,463 | (2,223) |
| FINANCING ACTIVITIES | | |
| Proceeds from revolving line of credit | | 30,000 |
| Principal payments of real estate borrowings | (5,682) | (660) |
| Proceeds from exercise of stock options | 250 | |
| Excess income tax benefit from exercise of stock options | 140 | |
| NET CASH (USED IN) PROVIDED BY FINANCING ACTIVITIES | (5,292) | 29,340 |
| INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 24,739 | (19,130) |

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| | | |
|--|--------|--------|
| Cash and cash equivalents at beginning of period | 38,479 | 28,190 |
|--|--------|--------|

| | | |
|--|-----------|----------|
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$ 63,218 | \$ 9,060 |
|--|-----------|----------|

See notes to consolidated financial statements.

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AVATAR HOLDINGS INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Unaudited)
June 30, 2006

(Dollars in thousands except share and per share data)

Basis of Statement Presentation and Summary of Significant Accounting Policies

The accompanying consolidated financial statements include the accounts of Avatar Holdings Inc. and all subsidiaries, partnerships and other entities in which Avatar Holdings Inc. (Avatar , we , us or our) has a controlling interest and variable interest entities for which we are deemed to be the primary beneficiary. Our investments in unconsolidated joint ventures in which we have less than a controlling interest are accounted for using the equity method. All significant intercompany accounts and transactions have been eliminated in consolidation.

The consolidated balance sheets as of June 30, 2006 and December 31, 2005, and the related consolidated statements of income for the six and three months ended June 30, 2006 and 2005 and the consolidated statements of cash flows for the six months ended June 30, 2006 and 2005 have been prepared in accordance with United States generally accepted accounting principles for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by United States generally accepted accounting principles for complete financial statement presentation. In the opinion of management, all adjustments necessary for a fair presentation of such financial statements have been included. Such adjustments consisted only of normal recurring items. Interim results are not necessarily indicative of results for a full year.

The preparation of the consolidated financial statements in accordance with United States generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and the accompanying notes. Actual results could differ from those estimates. Due to Avatar's normal operating cycle being in excess of one year, we present unclassified balance sheets.

The balance sheet as of December 31, 2005 was derived from audited financial statements included in our 2005 Form 10-K but does not include all disclosures required by United States generally accepted accounting principles. These consolidated financial statements should be read in conjunction with our December 31, 2005 audited financial statements in our 2005 Annual Report on Form 10-K and the notes to the consolidated financial statements included therein.

Reclassifications

Certain 2005 financial statement items have been reclassified to conform to the 2006 presentation.

Land and Other Inventories

Inventories consist of the following:

| | June 30, 2006 (Unaudited) | December 31, 2005 |
|--|---------------------------------|-------------------------|
| Land developed and in process of development | \$ 193,030 | \$ 176,540 |
| Land held for future development or sale | 90,884 | 84,667 |
| Dwelling units completed or under construction | 185,551 | 131,063 |
| Other | 665 | 573 |
| | \$ 470,130 | \$ 392,843 |

Table of Contents**Notes to Consolidated Financial Statements (dollars in thousands except share and per share data) (Unaudited)**
continued**Land and Other Inventories continued**

During the six months ended June 30 2006, we closed for a cash purchase price of approximately \$18,300 on the remaining phases of land in Poinciana which were classified as land inventory not owned and obligations related to land inventory not owned on the accompanying consolidated balance sheet as of December 31, 2005.

During the six and three months ended June 30, 2006, we realized pre-tax profits of \$28,189 and \$20,219, respectively, on revenues of \$38,946 and \$30,171, respectively, from commercial and industrial and other land sales. For the six and three months ended June 30, 2005, we realized pre-tax profits of \$6,909 and \$1,504, respectively, on revenues of \$8,017 and \$2,217, respectively, from commercial and industrial and other land sales.

For the six months ended June 30, 2006, pre-tax profits on sales of commercial and industrial land were \$23,468 on aggregate sales of \$25,132. Pre-tax profits on sales of other land were \$394 on aggregate sales of \$629. During the three months ended June 30, 2006, we realized pre-tax profits of \$15,718 on revenues of \$16,641 from sales of commercial and industrial land. We also realized, during the three months ended June 30, 2006, pre-tax profits of \$4,327 from the collection of a promissory note and accrued interest totaling \$13,185 from the sale of our equity interest in the Regalia Joint Venture which was sold on June 30, 2005 (discussed further below). Pre-tax profits on sales of other land were \$174 on aggregate sales of \$345.

During the six months ended June 30, 2005, pre-tax profits on sales of commercial and industrial land were \$5,384 on aggregate sales of \$5,932. Pre-tax profits on sales of other land were \$1,525 on aggregate sales of \$2,085. During the three months ended June 30, 2005, pre-tax profits on sales of commercial and industrial land were \$834 on aggregate sales of \$1,181. Pre-tax profits on sales of other land were \$670 on aggregate sales of \$1,036.

See Financial Information Relating to Industry Segments below.

Goodwill and Indefinite-Lived Intangible Assets

During the first quarter of 2006, we performed an interim impairment test in accordance with SFAS No. 142 *Goodwill and Intangible Assets* on the goodwill associated with the Harbor Islands community because facts and circumstances indicated a potential impairment. Based on this impairment test we determined that this goodwill was impaired as a result of the closing of the final housing unit in this community. Since the Harbor Islands community was completed during the first quarter of 2006, the associated goodwill of \$654 was written-off under the caption of Real Estate Expense in the consolidated statement of income for the six months ended June 30, 2006.

Notes, Mortgage Notes and Other Debt

On March 30, 2004, we issued \$120,000 aggregate principal amount of 4.50% Convertible Senior Notes due 2024 (the 4.50% Notes) in a private, unregistered offering, subsequent to which we filed, for the benefit of the 4.50% Notes holders, a shelf registration statement covering resales of the 4.50% Notes and the shares of our common stock issuable upon the conversion of the 4.50% Notes. Interest is payable semiannually on April 1 and October 1. The 4.50% Notes are senior, unsecured obligations and rank equal in right of payment to all of our existing and future unsecured and senior indebtedness. However, the 4.50% Notes are effectively subordinated to all of our existing and future secured debt to the extent of the collateral securing such indebtedness, and to all existing and future liabilities of our subsidiaries. Each \$1 in principal amount of the 4.50% Notes is convertible, at the option of the holder, at a conversion price of \$52.63, or 19.0006 shares of our common stock, upon the satisfaction of one of the following conditions: a) during any calendar quarter (but only during such calendar quarter) commencing after June 30, 2004 if the closing sale price of our common stock for at least 20 trading days in a period of 30 consecutive trading days ending on the last trading day of the preceding calendar quarter is more

Table of Contents**Notes to Consolidated Financial Statements (dollars in thousands except share and per share data) (Unaudited) continued****Notes, Mortgage Notes and Other Debt continued**

than 120% of the conversion price per share of common stock on such last day; or b) during the five business day period after any five-consecutive-trading-day period in which the trading price per \$1 principal amount of the 4.50% Notes for each day of that period was less than 98% of the product of the closing sale price for our common stock for each day of that period and the number of shares of common stock issuable upon conversion of \$1 principal amount of the 4.50% Notes, provided that if on the date of any such conversion that is on or after April 1, 2019, the closing sale price of Avatar's common stock is greater than the conversion price, then holders will receive, in lieu of common stock based on the conversion price, cash or common stock or a combination thereof, at our option, with a value equal to the principal amount of the 4.50% Notes plus accrued and unpaid interest, as of the conversion date. The satisfaction of these conditions has not been met as of June 30, 2006.

Avatar may, at its option, redeem for cash all or a portion of the 4.50% Notes at any time on or after April 5, 2011. Holders may require us to repurchase the 4.50% Notes for cash on April 1, 2011, April 1, 2014 and April 1, 2019 or in certain circumstances involving a designated event, as defined in the indenture for the 4.50% Notes, holders may require us to purchase all or a portion of their 4.50% Notes. In each case, Avatar will pay a repurchase price equal to 100% of their principal amount, plus accrued and unpaid interest, if any.

In conjunction with the offering, Avatar used approximately \$42,905 of the net proceeds from the offering to purchase 1,141,400 shares of our common stock in privately negotiated transactions at a price of \$37.59 per share. We used the balance of the net proceeds from the offering for general corporate purposes including acquisitions of land in Florida.

On September 20, 2005, Avatar entered into a Credit Agreement and a Guaranty Agreement for a \$100,000 (expandable up to \$175,000), four-year senior unsecured revolving credit facility (the Unsecured Credit Facility), by and among our wholly-owned subsidiary, Avatar Properties Inc., Wachovia Bank, National Association, and certain other financial institutions. This Unsecured Credit Facility replaced the three-year, \$100,000 revolving secured credit facility entered into on December 30, 2003. Interest on borrowings under the Unsecured Credit Facility ranges from LIBOR plus 1.75% to 2.25%. Our borrowing rate under the Unsecured Credit Facility as of June 30, 2006 was 7.08%.

The initial principal amount under the Unsecured Credit Facility is \$100,000; however, so long as no default or event of default has occurred and is continuing, increases may be requested, subject to lender approval, up to \$175,000. We received lender approval on October 21, 2005 to increase the principal amount under the Unsecured Credit Facility to \$125,000. This Unsecured Credit Facility includes a \$7,500 swing line commitment and had a \$10,000 sublimit for the issuance of standby letters of credit.

On May 25, 2006, we amended the Unsecured Credit Facility to clarify the timing of applicable interest rate adjustments and increase the availability for letters of credit from \$10,000 to \$50,000.

The Unsecured Credit Facility contains customary representations, warranties and covenants limiting liens, guaranties, mergers and consolidations, substantial asset sales, investments and loans. In addition, the Unsecured Credit Facility contains covenants to the effect that (i) we will maintain a minimum consolidated tangible net worth (as defined in the Unsecured Credit Facility), (ii) we shall maintain an adjusted EBITDA/debt service ratio (as defined in the Unsecured Credit Facility) of not less than 2.75 to 1.0, (iii) we will not permit the leverage ratio (as defined in the Unsecured Credit Facility) to exceed 2.0 to 1.0, and (iv) the sum of the net book value of unentitled land, entitled land, land under development and finished lots shall not exceed 150% of consolidated tangible net worth. Borrowings under the Unsecured Credit Facility may be limited based on the amount of borrowing base available. We are in compliance with these covenants as of June 30, 2006.

Table of Contents**Notes to Consolidated Financial Statements (dollars in thousands except share and per share data) (Unaudited)**
continued**Notes, Mortgage Notes and Other Debt continued**

In the event of a default under the Unsecured Credit Facility, including cross-defaults relating to specified other debt of Avatar or our consolidated subsidiaries in excess of \$1,000, the lenders may terminate the commitments under the Unsecured Credit Facility and declare the amounts outstanding, and all accrued interest, immediately due and payable.

Loans made and other obligations incurred under the Unsecured Credit Facility will mature on September 20, 2009; however, the Unsecured Credit Facility provides that once each fiscal year, we may request a twelve-month extension of the maturity date. As of June 30, 2006, we had borrowings totaling \$0 under the Unsecured Credit Facility and approximately \$101,902 was available for borrowing under the Unsecured Credit Facility, net of approximately \$23,098 outstanding letters of credit.

Payments of all amounts due under the Unsecured Credit Facility are guaranteed by Avatar Holdings Inc. pursuant to the Restated Guaranty Agreement dated as of October 21, 2005.

We made interest payments of \$3,717 and \$3,608 for the six months ended June 30, 2006 and 2005, respectively. Interest costs incurred of \$3,944 and \$3,679 were capitalized for the six months ended June 30, 2006 and 2005, respectively.

Warranty Costs

Warranty reserves for houses are established to cover potential costs for materials and labor with regard to warranty-type claims to be incurred subsequent to the closing of a house. Reserves are determined based on historical data and other relevant factors. We may have recourse against the subcontractors for claims relating to workmanship and materials. Warranty reserves are included in Accrued and Other Liabilities in the consolidated balance sheets.

During the six and three months ended June 30, 2006 and 2005 changes in the warranty accrual consisted of the following (unaudited):

| | Six Months | | Three Months | |
|---|------------|----------|--------------|----------|
| | 2006 | 2005 | 2006 | 2005 |
| Accrued warranty reserve, beginning of period | \$ 1,616 | \$ 1,370 | \$ 1,924 | \$ 983 |
| Estimated warranty expense | 1,830 | 1,145 | 881 | 655 |
| Amounts charged against warranty reserve | (1,572) | (1,305) | (931) | (428) |
| Accrued warranty reserve, end of period | \$ 1,874 | \$ 1,210 | \$ 1,874 | \$ 1,210 |

Earnings Per Share

We present earnings per share in accordance with SFAS No. 128, *Earnings Per Share*. Basic earnings per share is computed by dividing earnings available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of Avatar.

The weighted average number of shares outstanding in calculating basic earnings per share includes the issuance of 14,273 and 4,273 shares of Avatar common stock for the six and three months ended June 30, 2006, respectively, due to the exercise of stock options, restricted stock units and stock units. Avatar did not issue any shares of common stock during the six months ended June 30, 2005.

Table of Contents**Notes to Consolidated Financial Statements (dollars in thousands except share and per share data) (Unaudited)**
continued**Earnings Per Share continued**

The following table represents a reconciliation of the income from continuing operations, net income and weighted average shares outstanding for the calculation of basic and diluted earnings per share for the six and three months ended June 30, 2006 and 2005 (unaudited):

| | Six Months | | Three Months | |
|--|------------|------------|--------------|------------|
| | 2006 | 2005 | 2006 | 2005 |
| Numerator: | | | | |
| Basic earnings per share income from continuing operations | \$ 51,819 | \$ 24,249 | \$ 27,183 | \$ 10,240 |
| Interest on 4.50% Notes, net of tax | 1,633 | 1,650 | 816 | 823 |
| Diluted earnings per share income from continuing operations | \$ 53,452 | \$ 25,899 | \$ 27,999 | \$ 11,063 |
| Basic earnings per share net income | \$ 51,819 | \$ 23,559 | \$ 27,183 | \$ 9,389 |
| Interest on 4.50% Notes, net of tax | 1,633 | 1,650 | 816 | 823 |
| Diluted earnings per share net income | \$ 53,452 | \$ 25,209 | \$ 27,999 | \$ 10,212 |
| Denominator: | | | | |
| Basic weighted average shares outstanding | 8,189,053 | 8,058,129 | 8,193,703 | 8,058,129 |
| Effect of dilutive restricted stock | 153,516 | 181,826 | 163,941 | 189,176 |
| Effect of dilutive employee stock options | 37,824 | 41,773 | 38,081 | 41,392 |
| Effect of dilutive 4.50% Notes | 2,280,068 | 2,280,068 | 2,280,068 | 2,280,068 |
| Diluted weighted average shares outstanding | 10,660,461 | 10,561,796 | 10,675,793 | 10,568,765 |

Repurchase and Exchange of Common Stock

During the six and three months ended June 30, 2006, we did not repurchase shares of our common stock and/or the 4.50% Notes under previous authorizations by the Board of Directors to make purchases from time to time, in the open market, through privately negotiated transactions or otherwise, depending on market and business conditions and other factors. As of June 30, 2006, the remaining authorization is \$15,829.

Comprehensive Income

Net income and comprehensive income are the same for the six and three months ended June 30, 2006 and 2005.

Stock-Based Compensation

The Amended and Restated 1997 Incentive and Capital Accumulation Plan (2005 Restatement), as amended (the Incentive Plan) provides that stock options, including incentive stock options and non-qualified stock options; stock appreciation rights; stock awards; performance-conditioned stock awards (restricted stock units); and stock units may be granted to officers, employees and directors of Avatar. The exercise prices of stock options may not be less than the market value of our common stock on the date of grant. Stock option awards under the Incentive Plan generally expire 10 years after the date of grant.

Table of Contents**Notes to Consolidated Financial Statements (dollars in thousands except share and per share data) (Unaudited) continued****Stock-Based Compensation continued**

As of June 30, 2006, an aggregate of 1,105,829 shares of our Common Stock, subject to certain adjustments, were available for issuance under the Incentive Plan, including an aggregate of 785,323 options and stock units granted. There were 320,506 shares available for grant at June 30, 2006.

Prior to January 1, 2006, we accounted for our stock-based compensation plans in accordance with the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25) and related interpretations, as permitted by SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123). Accordingly, for restricted stock units granted, compensation expense was recognized in the consolidated statements of income prior to January 1, 2006 based on the market price of Avatar's common stock on the date the specified hurdle price was probable to be achieved, provided such provisions are applicable, or the date of grant. For stock options granted, no compensation expense was recognized in the consolidated statements of income prior to January 1, 2006 since all stock options granted had exercise prices greater than the market value of Avatar's stock on the grant date. Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123(R)) using the modified-prospective transition method. Under this transition method, compensation expense recognized during the six and three months ended June 30, 2006 included: (a) compensation expense for all share-based awards granted 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 expense for all share-based awards granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R). In accordance with the modified-prospective-transition method, results for periods prior to adoption have not been restated.

As a result of the adoption of SFAS No. 123(R), the charge to income from continuing operations before income taxes and net income for the six months ended June 30, 2006 was \$158 and \$98, respectively, and \$79 and \$49, respectively, for the three months ended June 30, 2006. The impact of adopting SFAS 123(R) on both basic and diluted earnings per share for the six months ended June 30, 2006 was \$0.01.

Prior to the adoption of SFAS No. 123(R), we presented all tax benefits related to deductions resulting from the exercise of restricted stock units and stock options as operating activities in the consolidated statements of cash flows. SFAS No. 123(R) requires that tax benefits resulting from tax deductions in excess of the compensation expense recognized for those options (excess tax benefits) be classified and reported as both an operating cash outflow and a financing cash inflow upon adoption.

SFAS No. 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure*, requires disclosure of pro forma income and pro forma income per share as if the fair value based method had been applied in measuring compensation expense. The following table summarizes pro forma net income and earnings per share in accordance with SFAS No. 123, for the six and three months ended June 30, 2005 had compensation expense for stock-based compensation awarded under our stock-based incentive compensation plan been based on fair value at the grant date. For purposes of this pro forma disclosure, the value of the stock options granted is estimated using the Black-Scholes option-pricing model and the Monte-Carlo option valuation model (like a lattice model) for restricted stock units granted.

Table of Contents**Notes to Consolidated Financial Statements (dollars in thousands except share and per share data) (Unaudited)**
continued**Stock-Based Compensation continued**

| | 2005 (Unaudited) | |
|---|------------------|-----------------|
| | Six Months | Three Months |
| Net income as reported | \$23,559 | \$9,389 |
| Add: Stock-based compensation expense included in reported net income, net of related tax expense | 908 | 459 |
| Deduct: stock-based compensation expense determined using the fair value method, net of related tax expense | (999) | (505) |
| Net income pro forma | \$23,468 | \$9,343 |
| Earnings Per Share: | | |
| Basic | | |
| As reported | \$ 2.92 | \$ 1.17 |
| Pro forma | \$ 2.91 | \$ 1.16 |
| Diluted | | |
| As reported | \$ 2.39 | \$ 0.96 |
| Pro forma | \$ 2.38 | \$ 0.96 |

Compensation expense related to the stock option and restricted stock unit awards during the six months ended June 30, 2006 was \$1,565, of which \$143 related to stock options and \$1,422 related to restricted stock units. Compensation expense related to the stock option and restricted stock awards during the three months ended June 30, 2006 was \$884, of which \$72 related to stock options and \$812 related to restricted stock units. During the six and three months ended June 30, 2005, compensation expense related to our restricted stock unit awards was \$1,465 and \$740, respectively. The income tax benefit recognized in the consolidated statements of income during the six and three months ended June 30, 2006 for the restricted stock unit awards was \$139 and \$100, respectively. The income tax benefit recognized in the consolidated statement of income during the six and three months ended June 30, 2005 for the restricted stock unit awards was \$331 and \$104, respectively.

Cash received from stock options exercised during the six months ended June 30, 2006 and 2005 was \$250 and \$0, respectively. The tax benefit related to the exercise of stock options and restricted stock units during the six and three months ended June 30, 2006 was \$140 and \$24, respectively.

The fair value of each stock option is estimated on the grant date using the Black-Scholes option-pricing model. No stock options were granted during the six months ended June 30, 2006 and 2005. A summary of the status of the stock options outstanding as of June 30, 2006 as well as the activity during the six months then ended is presented below (unaudited):

Table of Contents**Notes to Consolidated Financial Statements (dollars in thousands except share and per share data) (Unaudited)**
continued**Stock-Based Compensation continued**

| | 2006 | Weighted Average Exercise Price |
|----------------------------------|----------|--|
| Outstanding at beginning of year | 250,102 | \$ 25.00 |
| Exercised | (10,000) | 25.00 |
| Outstanding at end of period | 240,102 | \$ 25.00 |
| Exercisable at end of period | 120,102 | \$ 25.00 |

The weighted average remaining contractual life of stock options outstanding as of June 30, 2006 was 4.7 years. The total intrinsic value of stock options exercised during the six months ended June 30, 2006 was \$306.

Under SFAS No. 123(R), the fair value of restricted stock awards which contain a specified hurdle price condition is estimated on the grant date using the Monte-Carlo option valuation model (like a lattice model). Under SFAS No. 123(R), the fair value of restricted stock awards which do not contain a specified hurdle price condition is based on the market price of our common stock on the date of grant. A summary of the status of the restricted stock units outstanding as of June 30, 2006 as well as the activity during the six months then ended is presented below (unaudited):

| | 2006 | Weighted Average Grant Date Fair Value |
|----------------------------------|---------|---|
| Outstanding at beginning of year | 543,854 | \$ 25.10 |
| Granted | 3,200 | 57.54 |
| Forfeited | (800) | 51.06 |
| Outstanding at end of period | 546,254 | \$ 25.25 |

As of June 30, 2006, there was \$9,383 of unrecognized compensation expense related to unvested restricted stock units and unvested stock options, of which \$8,953 relates to restricted stock units and \$430 relates to stock options, which is expected to be recognized over a weighted-average period of 2.4 years.

During March 2003, we entered into earnings participation award agreements with certain executive officers providing for stock awards relating to achievement of performance goals. The cash award entitles the executives to a cash payment with respect to each fiscal year beginning 2003 and ending 2007 equal to a percentage of Avatar's gross profit (as defined) over minimum levels established. The stock award entitles the executives to receive a number of shares of our Common Stock having a fair market value (as defined) equal to a percentage of the excess of actual gross profit (as defined) from January 1, 2003 through December 31, 2007 over minimum levels established. Pursuant to these compensation agreements compensation expense of \$3,676 and \$0 was recognized for the six months ended

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June 30, 2006 and 2005, respectively, and \$2,158 and \$0 was recognized for the three months ended June 30, 2006 and 2005, respectively. The income tax benefit recognized in the consolidated statements of income during the six and three months ended June 30, 2006 for these stock awards was \$1,397 and \$820, respectively.

Table of Contents**Notes to Consolidated Financial Statements (dollars in thousands except share and per share data) (Unaudited)**
continued**Income Taxes**

The components of income tax expense from continuing operations for the six and three months ended June 30, 2006 and 2005 are as follows (unaudited):

| | Six Months | | Three Months | |
|--------------------------|------------|-----------|--------------|----------|
| | 2006 | 2005 | 2006 | 2005 |
| Current | | | | |
| Federal | \$ 27,387 | \$ 9,531 | \$ 15,474 | \$ 5,123 |
| State | 4,635 | 1,613 | 2,619 | 867 |
| Total current | 32,022 | 11,144 | 18,093 | 5,990 |
| Deferred | | | | |
| Federal | (3,783) | (783) | (914) | (1,051) |
| State | (640) | (132) | (154) | (177) |
| Total deferred | (4,423) | (915) | (1,068) | (1,228) |
| Total income tax expense | \$ 27,599 | \$ 10,229 | \$ 17,025 | \$ 4,762 |

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of deferred income tax assets and liabilities are as follows:

| | June 30, 2006 (unaudited) | December 31, 2005 |
|--|---------------------------------|-------------------------|
| Deferred income tax assets | | |
| Tax over book basis of land inventory | \$ 12,131 | \$ 13,142 |
| Unrecoverable land development costs | 2,679 | 2,427 |
| Tax over book basis of depreciable assets | 111 | (80) |
| Executive incentive compensation | 3,390 | 3,369 |
| Other | 2,224 | 3,263 |
| Total deferred income tax assets | 20,535 | 22,121 |
| Valuation allowance for deferred income tax assets | (12,083) | (14,053) |
| Deferred income tax after valuation allowance | 8,452 | 8,068 |
| Deferred income tax liabilities | | |
| Book over tax income recognized on Ocean Palms Joint Venture | | (4,245) |
| Net deferred income tax assets | \$ 8,452 | \$ 3,823 |

Table of Contents**Notes to Consolidated Financial Statements (dollars in thousands except share and per share data) (Unaudited)**
continued**Income Taxes continued**

We have recorded a valuation allowance of \$12,083 with respect to deferred income tax assets as of June 30, 2006. Included in the valuation allowance for deferred income tax assets is approximately \$545 which, if utilized, will be credited to additional paid-in capital. This valuation allowance was generated in years prior to reorganization on October 1, 1980. For the six months ended June 30, 2006, we decreased the valuation allowance by \$1,970 which is primarily attributable to the tax over book basis of land inventory.

A reconciliation of income tax expense from continuing operations to the expected income tax expense at the federal statutory rate of 35% for the six and three months ended June 30, 2006 and 2005 is as follows (unaudited):

| | Six Months | | Three Months | |
|--|------------|-----------|--------------|----------|
| | 2006 | 2005 | 2006 | 2005 |
| Income tax expense computed at statutory rate | \$ 27,796 | \$ 12,067 | \$ 15,472 | \$ 5,250 |
| State income tax, net of federal benefit | 2,328 | 1,234 | 1,295 | 537 |
| Other, net | (555) | (72) | (297) | (25) |
| Change in valuation allowance on deferred tax assets | (1,970) | (3,000) | 555 | (1,000) |
| Income tax expense | \$ 27,599 | \$ 10,229 | \$ 17,025 | \$ 4,762 |

We made income tax payments of approximately \$44,850 and \$7,000 for the six months ended June 30, 2006 and 2005, respectively.

Investments in Consolidated and Unconsolidated Joint Ventures

In December 2003, the FASB issued Interpretation No. 46(R) (FIN 46(R)), (which further clarified and amended FIN 46, *Consolidation of Variable Interest Entities*) which requires the consolidation of entities in which an enterprise absorbs a majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both, as a result of ownership, contractual or other financial interests in the entity.

Investments in Consolidated Joint Venture

On March 17, 2004, a subsidiary, Avatar Regalia, Inc., entered into a joint venture for possible investment in and/or development of Regalia (the Regalia Joint Venture), a luxury residential highrise condominium on an approximately 1.18-acre oceanfront site in Sunny Isles Beach, Florida (the Property), approximately three miles south of Hollywood, Florida whereby we had a 50% equity interest in the Regalia Joint Venture. We evaluated the impact of FIN 46(R) as it relates to our equity interest in the Regalia Joint Venture and determined that we were the primary beneficiary since we were the entity that will absorb a majority of the losses and/or receive a majority of the expected residual returns (profits). Thus, under the provisions of FIN 46(R), we commenced consolidating the Regalia Joint Venture into our financial statements during the first quarter of 2004. On June 30, 2005, we assigned our 50% equity interest in the Regalia Joint Venture to our 50% equity partner for which we received a promissory note in the amount of approximately \$11,500 secured by a mortgage on the Property. Under the terms of the promissory note, we could advance up to an additional \$750. The interest rate on this promissory note was 8% per annum. Unpaid principal and interest under this promissory note was due and payable on June 30, 2006. The consolidated assets and liabilities of the Regalia Joint Venture were reflected in the accompanying consolidated

Table of Contents**Notes to Consolidated Financial Statements (dollars in thousands except share and per share data) (Unaudited) continued****Investments in Consolidated and Unconsolidated Joint Ventures continued**

balance sheets as of December 31, 2005 as Assets of business transferred under contractual arrangements and Liabilities of business transferred under contractual arrangement because until June 30, 2006 the risks of ownership had not been transferred to allow us to recognize this transaction as a sale. On June 30, 2006, we received \$13,185 for payment of the promissory note and accrued interest. Payment of the promissory note and accrued interest allowed us for accounting purposes to recognize this transaction as a sale whereby we recognized a pre-tax gain of \$4,327.

Investments in Unconsolidated Joint Ventures

As of June 30, 2006, we had equity interests in two joint ventures (excluding Ocean Palms Joint Venture described below) formed for the acquisition and/or development of land in which we do not have a controlling interest. These entities typically meet the criteria of VIEs under FIN 46(R). We evaluated the impact of FIN 46(R) as it relates to these joint ventures and determined that we are not the primary beneficiary since we are not the entity that will absorb a majority of the losses and/or receive a majority of the expected residual returns (profits). Therefore, these joint ventures are recorded using the equity method of accounting. Our maximum exposure related to our investment in these entities as of June 30, 2006 is the amount invested of \$8,786. These entities have assets and liabilities totaling approximately \$17,673 and \$140, respectively, as of June 30, 2006.

In December 2002, our subsidiary, Avatar Ocean Palms, Inc., entered into a joint venture in which it committed to fund up to \$25,000 for the development of Ocean Palms (the Ocean Palms Joint Venture), a 38-story, 240-unit highrise condominium on a 3.5-acre oceanfront site in Hollywood, Florida. We evaluated the impact of FIN 46(R) as it related to our equity interest in the Ocean Palms Joint Venture and determined that it does not qualify as a variable interest entity; thus, the Ocean Palms Joint Venture is not subject to the consolidation provisions of FIN 46(R). We are accounting for our investment in the Ocean Palms Joint Venture under the equity method whereby we recognize our share of profits and losses. Construction by the Ocean Palms Joint Venture of its highrise condominium in Hollywood, Florida was completed as of June 30, 2006. Closings of units commenced during February 2006 and were completed as of June 30, 2006. As of June 30, 2006, the Ocean Palms Joint Venture realized cash proceeds from closings and the construction financing was repaid. We received cash distributions of \$48,838 during the six months ended June 30, 2006 representing \$29,132 from cumulative earnings generated by closings of condominium units at Ocean Palms and \$19,706 from our investment in the Ocean Palms Joint Venture. We recognized cumulative earnings of \$33,661 from inception through June 30, 2006 from our investment in the Ocean Palms Joint Venture.

On March 9, 2004, we agreed to lend up to \$5,000 to the sole stockholder of the Ocean Palms Joint Venture member, represented by a two-year interest-bearing promissory note. We recognized interest income from this promissory note of \$289 and \$30 for the six and three months ended June 30, 2006, respectively, and \$333 and \$179 for the six and three months ended June 30, 2005, respectively. Advances under the promissory note were subject to certain requirements and conditions related to sales at Ocean Palms, which conditions and requirements were satisfied during July 2004. During April 2006 the advances under this promissory note and accrued interest of \$5,455 were repaid by the Ocean Palms Joint Venture member.

Table of Contents**Notes to Consolidated Financial Statements (dollars in thousands except share and per share data) (Unaudited)**
continued**Investments in Consolidated and Unconsolidated Joint Ventures continued**

The following is the Ocean Palms Joint Venture's condensed consolidated balance sheets as of June 30, 2006 and December 31, 2005:

| | June 30, 2006 (unaudited) | December 31, 2005 |
|---|---------------------------------|-------------------------|
| Assets: | | |
| Cash and cash equivalents | \$ 2,136 | \$ 1,073 |
| Restricted cash | 316 | 28,885 |
| Customer receivables | | 146,114 |
| Other assets | 31 | 915 |
| Total assets | \$ 2,483 | \$ 176,987 |
| Liabilities and Members' Capital: | | |
| Accounts payable and accrued liabilities | \$ 1,896 | \$ 16,824 |
| Notes payable | | 77,445 |
| Equity of: | | |
| Avatar | 294 | 47,363 |
| Joint venture partner | 293 | 35,355 |
| Total liabilities and members' capital | \$ 2,483 | \$ 176,987 |

The following is the Ocean Palms Joint Venture's condensed consolidated statements of income for the six and three months ended June 30, 2006 and 2005 (unaudited):

| | Six Months | | Three Months | |
|---------------------------------|-----------------|------------------|---------------|------------------|
| | 2006 | 2005 | 2006 | 2005 |
| Revenues: | | | | |
| Sales of condominiums | \$ 6,617 | \$ 80,281 | \$ 1,281 | \$ 30,450 |
| Interest and other income | 104 | 1,575 | 4 | 668 |
| Total revenues | 6,721 | 81,856 | 1,285 | 31,118 |
| Operating expenses: | | | | |
| Cost of sales | 3,688 | 54,066 | 1,030 | 20,554 |
| Operating costs and expenses | 41 | 172 | 10 | 62 |
| Total operating expenses | 3,729 | 54,238 | 1,040 | 20,616 |
| Net income | \$ 2,992 | \$ 27,618 | \$ 245 | \$ 10,502 |

Our share of the net income from the Ocean Palms Joint Venture was \$1,770 and \$12,357 for the six months ended June 30, 2006 and 2005, respectively, and \$115 and \$4,788 for the three months ended June 30, 2006 and 2005,

respectively. Our investment in the Ocean Palms Joint Venture is \$294 and \$47,363 as of June 30, 2006 and December 31, 2005, respectively.

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Notes to Consolidated Financial Statements (dollars in thousands except share and per share data) (Unaudited)
continued

Recently Issued Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN 48 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. The interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006, which is January 1, 2007 for us. We are currently evaluating the provisions of FIN 48 and assessing the impact it may have on our financial position and results of operations.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*, which replaces APB No. 20, *Accounting Changes* and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*. SFAS No. 154 retained accounting guidance related to changes in estimates, changes in a reporting entity and error corrections. The statement requires retrospective application of changes in an accounting principle to prior periods' financial statements unless it is impracticable to determine the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005, which was January 1, 2006 for us. The adoption of SFAS No. 154 did not have a material impact on our financial position or results of operations.

Contingencies

We are involved in various pending litigation matters primarily arising in the normal course of our business. Although the outcome of these matters cannot be determined, management believes that the resolution thereof will not have a material effect on our business or financial statements.

Discontinued Operations

During the second quarter of 2005, we entered into a non-binding letter of intent for the sale of the stock of Rio Rico Utilities, Inc., our water and wastewater utilities operations in Rio Rico, Arizona, which closed during the fourth quarter of 2005. In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, a disposal group classified as held for sale shall be measured at the lower of its carrying amount or fair value less costs to sell. Therefore, we recorded an estimated loss on the disposal of Rio Rico Utilities of \$1,683 for the six and three months ended June 30, 2005. The operating results for the six and three months ended June 30, 2005 have been segregated from continuing operations and reported as discontinued operations in the accompanying consolidated statements of income. Revenues from Rio Rico Utilities for the six and three months ended June 30, 2005 were \$1,400 and \$754, respectively.

Table of Contents**Notes to Consolidated Financial Statements (dollars in thousands except share and per share data) (Unaudited)**
continued**Financial Information Relating To Industry Segments**

The following table summarizes Avatar's information for reportable segments for the six and three months ended June 30, 2006 and 2005 (unaudited):

| | Six Months | | Three Months | |
|---|------------|------------|--------------|------------|
| | 2006 | 2005 | 2006 | 2005 |
| Revenues: | | | | |
| Segment revenues | | | | |
| Primary residential | \$ 181,371 | \$ 119,039 | \$ 85,895 | \$ 64,617 |
| Active adult community | 99,097 | 67,544 | 51,246 | 38,449 |
| Commercial and industrial and other land sales | 38,946 | 8,017 | 30,171 | 2,217 |
| Other operations | 4,035 | 2,801 | 1,723 | 1,532 |
| | 323,449 | 197,401 | 169,035 | 106,815 |
| Unallocated revenues | | | | |
| Interest income | 1,517 | 682 | 880 | 328 |
| Other | 937 | 559 | 774 | 276 |
| Total revenues | \$ 325,903 | \$ 198,642 | \$ 170,689 | \$ 107,419 |
| Operating income: | | | | |
| Segment operating income | | | | |
| Primary residential | \$ 44,384 | \$ 25,031 | \$ 20,709 | \$ 13,308 |
| Active adult community | 20,269 | 6,061 | 10,496 | 3,908 |
| Commercial and industrial and other land sales | 28,189 | 6,909 | 20,219 | 1,504 |
| Other operations | 1,764 | 838 | 666 | 520 |
| | 94,606 | 38,839 | 52,090 | 19,240 |
| Unallocated income (expenses) | | | | |
| Equity earnings from unconsolidated joint ventures | 1,720 | 12,324 | 90 | 4,755 |
| Interest income | 1,517 | 682 | 880 | 328 |
| General and administrative expenses | (13,771) | (12,244) | (7,199) | (6,234) |
| Interest expense | | (461) | | |
| Other | (4,654) | (4,662) | (1,653) | (3,087) |
| Income from continuing operations before income taxes | \$ 79,418 | \$ 34,478 | \$ 44,208 | \$ 15,002 |

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (dollars in thousands except share and per share data)****RESULTS OF OPERATIONS**

The discussion in this section may contain forward-looking statements within the meaning of the Private Securities Litigation Act of 1995. Please see our discussion under the heading "Forward-Looking Statements" below.

In the preparation of our financial statements, we apply United States generally accepted accounting principles. The application of generally accepted accounting principles may require management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying results. For a description of our accounting policies, refer to Avatar Holdings Inc.'s 2005 Annual Report on Form 10-K.

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the consolidated financial statements and notes thereto included elsewhere in this Form 10-Q.

The following table provides a comparison of certain financial data related to our operations for the six and three months ended June 30, 2006 and 2005:

| | Six Months | | Three Months | |
|--|------------|------------|--------------|-----------|
| | 2006 | 2005 | 2006 | 2005 |
| Operating income: | | | | |
| Primary residential | | | | |
| Revenues | \$ 181,371 | \$ 119,039 | \$ 85,895 | \$ 64,617 |
| Expenses | 136,987 | 94,008 | 65,186 | 51,309 |
| Segment operating income | 44,384 | 25,031 | 20,709 | 13,308 |
| Active adult community | | | | |
| Revenues | 99,097 | 67,544 | 51,246 | 38,449 |
| Expenses | 78,828 | 61,483 | 40,750 | 34,541 |
| Segment operating income | 20,269 | 6,061 | 10,496 | 3,908 |
| Commercial and industrial and other land sales | | | | |
| Revenues | 38,946 | 8,017 | 30,171 | 2,217 |
| Expenses | 10,757 | 1,108 | 9,952 | 713 |
| Segment operating income | 28,189 | 6,909 | 20,219 | 1,504 |
| Other operations | | | | |
| Revenues | 4,035 | 2,801 | 1,723 | 1,532 |
| Expenses | 2,271 | 1,963 | 1,057 | 1,012 |
| Segment operating income | 1,764 | 838 | 666 | 520 |
| Operating income | 94,606 | 38,839 | 52,090 | 19,240 |
| Unallocated income (expenses): | | | | |
| Equity earnings from unconsolidated joint ventures | 1,720 | 12,324 | 90 | 4,755 |
| Interest income | 1,517 | 682 | 880 | 328 |
| General and administrative expenses | (13,771) | (12,244) | (7,199) | (6,234) |

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| | | | | |
|-----------------------------------|-----------|-----------|-----------|----------|
| Interest expense | | (461) | | |
| Other real estate expenses | (4,654) | (4,662) | (1,653) | (3,087) |
| Income from continuing operations | 79,418 | 34,478 | 44,208 | 15,002 |
| Income tax expense | (27,599) | (10,229) | (17,025) | (4,762) |
| Loss from discontinued operations | | (690) | | (851) |
| Net income | \$ 51,819 | \$ 23,559 | \$ 27,183 | \$ 9,389 |

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (dollars in thousands except share and per share data) continued****RESULTS OF OPERATIONS** continued

Data from single-family primary residential and active adult homebuilding operations for the six and three months ended June 30, 2006 and 2005 is summarized as follows:

| | Six Months | | Three Months | |
|--|------------|-----------|--------------|-----------|
| | 2006 | 2005 | 2006 | 2005 |
| Units closed | | | | |
| Number of units | 972 | 763 | 456 | 421 |
| Aggregate dollar volume | \$272,732 | \$179,885 | \$134,204 | \$100,006 |
| Average price per unit | \$ 281 | \$ 236 | \$ 294 | \$ 238 |
| Contracts signed, net of cancellations | | | | |
| Number of units | 670 | 1,117 | 242 | 441 |
| Aggregate dollar volume | \$239,597 | \$324,950 | \$ 83,074 | \$145,211 |
| Average price per unit | \$ 358 | \$ 291 | \$ 343 | \$ 329 |
| Backlog at June 30 | | | | |
| Number of units | 1,763 | 2,542 | | |
| Aggregate dollar volume | \$601,345 | \$669,842 | | |
| Average price per unit | \$ 341 | \$ 264 | | |

In addition to development of single-family residential communities, we are an equity partner in the Ocean Palms Joint Venture for development and construction of a 240-unit highrise condominium. Since the commencement of sales in 2003 through June 30, 2006, all 240 units were sold at an aggregate sales volume of \$203,717. Closings commenced in February 2006 and were completed as of June 30, 2006.

The number of units sold during the six and three months ended June 30, 2006 compared to the same periods in 2005 declined by 40% and 45.1%, respectively, while the dollar volume of housing contracts signed declined by 26.3% and 42.8%, respectively. The decline in sales volume for the six months ended June 30, 2006 continues to reflect the accelerating softening of the market for new single-family and multi-family residences which began in the third quarter of 2005. We continue to experience a further increase in the rate of cancellations of home sales. Most of our communities are located in Florida, where there is the continued availability of an excess of investor and speculator-owned units for sale and an increasing use of various sales incentives by residential builders in our markets, including Avatar.

We achieved a substantial increase in home closings during the six months ended June 30, 2006 compared to the six months ended June 30, 2005. The number of units closed increased by 27.4% and the dollar volume by 51.6%. We anticipate that we will close in excess of 80% of the homes in backlog as of June 30, 2006 during the subsequent 12-month period.

Net income for the six and three months ended June 30, 2006 was \$51,819 or \$5.01 per diluted share (\$6.33 per basic share) and \$27,183 or \$2.62 per diluted share (\$3.32 per basic share), respectively, compared to net income of \$23,559 or \$2.39 per diluted share (\$2.92 per basic share) and \$9,389 or \$0.96 per diluted share (\$1.17 per basic share) for the six and three months ended June 30, 2005, respectively. The increase in net income for the six and three month periods was primarily due to increased profitability of primary residential operations, active adult operating results and commercial and industrial land sales. The increase in net income for the six and three months ended June 30, 2006 was partially mitigated by a decrease in earnings recognized from an unconsolidated joint venture and increases in general and administrative expenses.

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (dollars in thousands except share and per share data) continued****RESULTS OF OPERATIONS** continued

Revenues from primary residential operations increased \$62,332 or 52.4% and \$21,278 or 32.9%, respectively, for the six and three months ended June 30, 2006 compared to the same periods in 2005. Expenses from primary residential operations increased \$42,979 or 45.7% and \$13,877 or 27.0%, respectively, for the six and three months ended June 30, 2006 compared to the same periods in 2005. The increase in revenues is attributable to increased closings at Poinciana, Bellalago, Cory Lake Isles and Rio Rico and higher average price per unit closed in all primary residential communities. The increase in expenses is attributable to higher volume of closings and the associated costs related to price increases for materials and services.

Revenues from active adult operations increased \$31,553 or 46.7% and \$12,797 or 33.3%, respectively, for the six and three months ended June 30, 2006 compared to the same periods in 2005. Expenses from active adult operations increased \$17,345 or 28.2% and \$6,209 or 18.0%, respectively, for the six and three months ended June 30, 2006 compared to the same periods in 2005. The increase in revenues is attributable to increased closings and higher average price per unit closed. The increase in expenses is attributable to higher volume of closings and the associated costs related to price increases for materials and services.

Revenues from commercial and industrial and other land sales increased \$30,929 and \$27,954, respectively, for the six and three months ended June 30, 2006 compared to the same periods in 2005. Expenses from commercial and industrial and other land sales increased \$9,649 and \$9,239, respectively, for the six and three months ended June 30, 2006 compared to the same periods in 2005. For the six months ended June 30, 2006, pre-tax profits on sales of commercial and industrial land were \$23,468 on aggregate sales of \$25,132. Pre-tax profits on sales of other land were \$394 on aggregate sales of \$629. During the three months ended June 30, 2006, we realized pre-tax profits of \$15,718 on revenues of \$16,641 from sales of commercial and industrial land. We also realized, during the three months ended June 30, 2006, pre-tax profits of \$4,327 from the collection of a promissory note and accrued interest totaling \$13,185 from the sale of our equity interest in the Regalia Joint Venture which was sold on June 30, 2005. Pre-tax profits on sales of other land were \$174 on aggregate sales of \$345. During the six months ended June 30, 2005, pre-tax profits on sales of commercial and industrial land were \$5,384 on aggregate sales of \$5,932. Pre-tax profits on sales of other land were \$1,525 on aggregate sales of \$2,085. During the three months ended June 30, 2005, pre-tax profits on sales of commercial and industrial land were \$834 on aggregate sales of \$1,181. Pre-tax profits on sales of other land were \$670 on aggregate sales of \$1,036. The amount and types of commercial and industrial and other land sold vary from year to year depending upon demand, ensuing negotiations and the timing of the closings of these sales.

Equity earnings from unconsolidated joint ventures represent our proportionate share of profits and losses from our investment in unconsolidated joint ventures whereby we account for our investment under the equity method. We recognized \$1,770 and \$115 of earnings for the six and three months ended June 30, 2006 and 2005, respectively, compared to \$12,357 and \$4,788 of earnings for the six and three months ended June 30, 2005, respectively, from our investment in the Ocean Palms Joint Venture. Earnings from the Ocean Palms Joint Venture are recognized on the percentage of completion method of accounting, and as of June 30, 2006 substantially all earnings have been recognized. Construction of the highrise condominium building was completed as of June 30, 2006. Closings of units commenced in February 2006 and were completed as of June 30, 2006.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (dollars in thousands except share and per share data) continued

RESULTS OF OPERATIONS continued

General and administrative expenses increased \$1,527 or 12.5% and \$965 or 15.5% for the six and three months ended June 30, 2006, respectively, compared to the same periods in 2005. The increase was primarily due to increases in executive incentive compensation and compensation expense.

Interest expense decreased \$461 or 100% for the six months ended June 30, 2006, respectively, compared to the same periods in 2005. The decrease is primarily attributable to the increase in the amount of interest expense capitalized due to increases in development and construction activities in our various projects.

During the second quarter of 2005, we entered into a non-binding letter of intent for the sale of the stock of Rio Rico Utilities, Inc., our water and wastewater utilities operations in Rio Rico, Arizona, which closed during the fourth quarter of 2005. In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, a disposal group classified as held for sale shall be measured at the lower of its carrying amount or fair value less costs to sell. Therefore, we recorded an estimated loss on the disposal of Rio Rico Utilities of \$1,683 for the six and three months ended June 30, 2005. The operating results for the six and three months ended June 30, 2005 have been segregated from continuing operations and reported as discontinued operations in the accompanying consolidated statements of income. Revenues from Rio Rico Utilities for the six and three months ended June 30, 2005 were \$1,400 and \$754, respectively.

Income tax expense was provided for at an effective tax rate of 34.8% and 38.5% for the six and three months ended June 30, 2006, respectively, compared to 29.4% and 31.1% for the six and three months ended June 30, 2005, respectively. The decrease in the effective tax rate for the six months ended June 30, 2006 and 2005 as compared to the federal and state statutory rate of 38% is due to a reduction to the valuation allowance for deferred tax assets of \$1,970 and \$3,000, respectively. The decrease in the effective tax rate for the three months ended June 30, 2005 as compared to the federal and state statutory rate of 38% is due to a reduction to the valuation allowance for deferred tax assets of \$1,000.

LIQUIDITY AND CAPITAL RESOURCES

Our real estate business strategy is designed to capitalize on our competitive advantages and emphasize higher profit margin businesses by concentrating on the development and management of active adult communities, primary residential communities, and utilizing commercial and industrial development to maximize the value of our residential community developments. We also seek to identify additional sites that are suitable for development consistent with our business strategy and anticipate that we will acquire or develop them directly or through joint venture, partnership or management arrangements. Our primary business activities are capital intensive in nature. Significant capital resources are required to finance planned primary residential and active adult communities, homebuilding construction in process, community infrastructure, selling expenses, new projects and working capital needs, including funding of debt service requirements and the carrying cost of land.

Our operating cash flows fluctuate relative to the status of development within existing communities, expenditures for land, new developments or other real estate activities and sales of various homebuilding product lines within those communities and other developments. From time to time we have generated, and may continue to generate, additional cash flow through sales of non-core assets.

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (dollars in thousands except share and per share data) continued**
LIQUIDITY AND CAPITAL RESOURCES continued

On September 20, 2005, we entered into a Credit Agreement and a Guaranty Agreement for a \$100,000 (expandable up to \$175,000), four-year senior unsecured revolving credit facility (the "Unsecured Credit Facility"), by and among our wholly-owned subsidiary, Avatar Properties Inc., Wachovia Bank, National Association, and certain other financial institutions. This Unsecured Credit Facility replaced the three-year, \$100,000 revolving secured credit facility entered into on December 30, 2003. Interest on borrowings under the Unsecured Credit Facility ranges from LIBOR plus 1.75% to 2.25%. Our borrowing rate under the Unsecured Credit Facility as of June 30, 2006 was 7.08%.

The initial principal amount under the Unsecured Credit Facility is \$100,000; however, so long as no default or event of default has occurred and is continuing, increases may be requested, subject to lender approval, up to \$175,000. We received lender approval on October 21, 2005 to increase the principal amount under the Unsecured Credit Facility to \$125,000. This Unsecured Credit Facility includes a \$7,500 swing line commitment and had a \$10,000 sublimit for the issuance of standby letters of credit.

On May 25, 2006, we amended the Unsecured Credit Facility to clarify the timing of applicable interest rate adjustments and increase the availability for letters of credit from \$10,000 to \$50,000.

The Unsecured Credit Facility contains customary representations, warranties and covenants limiting liens, guaranties, mergers and consolidations, substantial asset sales, investments and loans. In addition, the Unsecured Credit Facility contains covenants to the effect that (i) we will maintain a minimum consolidated tangible net worth (as defined in the Unsecured Credit Facility), (ii) we shall maintain an adjusted EBITDA/debt service ratio (as defined in the Unsecured Credit Facility) of not less than 2.75 to 1.0, (iii) we will not permit the leverage ratio (as defined in the Unsecured Credit Facility) to exceed 2.0 to 1.0, and (iv) the sum of the net book value of unentitled land, entitled land, land under development and finished lots shall not exceed 150% of consolidated tangible net worth. Borrowings under the Unsecured Credit Facility may be limited based on the amount of borrowing base available. We are in compliance with these covenants as of June 30, 2006.

In the event of a default under the Unsecured Credit Facility, including cross-defaults relating to specified other debt of Avatar or our consolidated subsidiaries in excess of \$1,000, the lenders may terminate the commitments under the Unsecured Credit Facility and declare the amounts outstanding, and all accrued interest, immediately due and payable.

Loans made and other obligations incurred under the Unsecured Credit Facility will mature on September 20, 2009; however, the Unsecured Credit Facility provides that once each fiscal year, we may request a twelve-month extension of the maturity date. As of June 30, 2006, we had borrowings totaling \$0 under the Unsecured Credit Facility and approximately \$101,902 was available for borrowing under the Unsecured Credit Facility, net of approximately \$23,098 outstanding letters of credit.

Payments of all amounts due under the Unsecured Credit Facility are guaranteed by Avatar Holdings Inc. pursuant to the Restated Guaranty Agreement dated as of October 21, 2005.

On March 30, 2004, we issued \$120,000 aggregate principal amount of 4.50% Convertible Senior Notes due 2024 (the "4.50% Notes") in a private, unregistered offering, subsequent to which we filed, for the benefit of the 4.50% Notes holders, a shelf registration statement covering resales of the 4.50% Notes and the shares of our common stock issuable upon the conversion of the 4.50% Notes. Interest is payable semiannually on April 1 and October 1. The 4.50% Notes are senior, unsecured obligations and rank equal in right of payment to all of our existing and future unsecured and senior indebtedness. However, the 4.50% Notes are effectively subordinated to

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (dollars in thousands except share and per share data) continued**
LIQUIDITY AND CAPITAL RESOURCES continued

all of our existing and future secured debt to the extent of the collateral securing such indebtedness, and to all existing and future liabilities of our subsidiaries. Each \$1 in principal amount of the 4.50% Notes is convertible, at the option of the holder, at a conversion price of \$52.63, or 19.0006 shares of our common stock, upon the satisfaction of one of the following conditions: a) during any calendar quarter (but only during such calendar quarter) commencing after June 30, 2004 if the closing sale price of our common stock for at least 20 trading days in a period of 30 consecutive trading days ending on the last trading day of the preceding calendar quarter is more than 120% of the conversion price per share of common stock on such last day; or b) during the five business day period after any five-consecutive-trading-day period in which the trading price per \$1 principal amount of the 4.50% Notes for each day of that period was less than 98% of the product of the closing sale price for our common stock for each day of that period and the number of shares of common stock issuable upon conversion of \$1 principal amount of the 4.50% Notes, provided that if on the date of any such conversion that is on or after April 1, 2019, the closing sale price of Avatar's common stock is greater than the conversion price, then holders will receive, in lieu of common stock based on the conversion price, cash or common stock or a combination thereof, at our option, with a value equal to the principal amount of the 4.50% Notes plus accrued and unpaid interest, as of the conversion date. The satisfaction of these conditions has not been met as of June 30, 2006.

We may, at our option, redeem for cash all or a portion of the 4.50% Notes at any time on or after April 5, 2011. Holders may require us to repurchase the 4.50% Notes for cash on April 1, 2011, April 1, 2014 and April 1, 2019 or in certain circumstances involving a designated event, as defined in the indenture for the 4.50% Notes, holders may require us to purchase all or a portion of their 4.50% Notes. In each case, we will pay a repurchase price equal to 100% of their principal amount, plus accrued and unpaid interest, if any.

In conjunction with the offering, we used approximately \$42,905 of the net proceeds from the offering to purchase 1,141,400 shares of our common stock in privately negotiated transactions at a price of \$37.59 per share. We used the balance of the net proceeds from the offering for general corporate purposes including acquisitions of land in Florida.

During the six months ended June 30, 2006, we closed for a cash purchase price of approximately \$18,300 on the remaining phases of land in Poinciana which was classified as land inventory not owned and obligations related to land inventory not owned on the accompanying consolidated balance sheet as of December 31, 2005.

During the six months ended June 30, 2006, we did not repurchase shares of our common stock and/or the 4.50% Notes under previous authorizations by the Board of Directors to make purchases from time to time, in the open market, through privately negotiated transactions or otherwise, depending on market and business conditions and other factors. As of June 30, 2006, the remaining authorization is \$15,829.

Construction by the Ocean Palms Joint Venture of its highrise condominium in Hollywood, Florida was completed as of June 30, 2006. Closings of units commenced during February 2006 and were completed as of June 30, 2006. As of June 30, 2006, the Ocean Palms Joint Venture realized cash proceeds from closings and the construction financing was repaid. We received cash distributions of \$48,838 during the six months ended June 30, 2006 representing \$29,132 from cumulative earnings generated by closings of condominium units at Ocean Palms and \$19,706 from our investment in the Ocean Palms Joint Venture.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (dollars in thousands except share and per share data) continued
LIQUIDITY AND CAPITAL RESOURCES continued

On March 9, 2004, we agreed to lend up to \$5,000 to the sole stockholder of the Ocean Palms Joint Venture member, represented by a two-year interest-bearing promissory note. We recognized interest income from this promissory note of \$289 and \$30 for the six and three months ended June 30, 2006, respectively, and \$333 and \$179 for the six and three months ended June 30, 2005, respectively. Advances under the promissory note were subject to certain requirements and conditions related to sales at Ocean Palms, which conditions and requirements were satisfied during July 2004. During April 2006 the advances under this promissory note and accrued interest of \$5,455 were repaid by the Ocean Palms Joint Venture member.

For the six months ended June 30, 2006, net cash provided by operating activities amounted to \$6,568, primarily as a result of net income of \$51,819, an increase in customer deposits of \$2,328, distributions of earnings from an unconsolidated joint venture of \$29,132, proceeds from the collection of a promissory note and accrued interest totaling \$13,185 from the sale of our equity interest in the Regalia Joint Venture and proceeds from the sales of commercial and industrial and other land sales partially offset by increases in land and other inventories of \$80,075 and decreases in accounts payable and accrued liabilities of \$10,968. Contributing to the increase in inventories for the six months ended June 30, 2006 were land acquisitions of approximately \$18,300 and expenditures on construction and land development of \$61,775. Net cash provided by investing activities amounted to \$23,463 primarily as a result of distributions of capital from an unconsolidated joint venture of \$19,706 and return of advances of \$4,910 from a promissory note to our Ocean Palms Joint Venture member offset by expenditures of \$736 for investments in property, plant and equipment, as well as expenditures of \$417 for investments in unconsolidated joint ventures. Net cash used in financing activities of \$5,292 resulted from repayment of real estate debt of \$5,682 partially offset by proceeds of \$250 from the exercise of stock options.

For the six months ended June 30, 2005, net cash used in operating activities amounted to \$46,247, primarily as a result of increases in land and other inventories of \$67,301 partially offset by an increase in customer deposits of \$15,868. Contributing to the increase in inventories for the six months ended June 30, 2005 were land acquisitions of \$33,100 and expenditures on construction and land development of approximately \$34,201. Net cash used in investing activities amounted to \$2,223, as a result of expenditures of \$825 for investments in property, plant and equipment, expenditures of \$888 for investment in an unconsolidated joint venture and advances under promissory note of \$510. Net cash provided by financing activities of \$29,340 resulted from borrowings of \$30,000 from a revolving line of credit partially offset by repayment of real estate debt of \$660.

Cash flow generated through our homebuilding operations has been adversely affected by the increase in the rate of cancellations of existing home sales contracts.

However, we anticipate that cash flow generated through profitable operations, sales of commercial and industrial land, sales of non-core assets and external borrowings, positions us to be able to continue to acquire new development opportunities and expand operations at our existing communities, as well as to commence development of new projects on properties currently owned and/or to be acquired.

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (dollars in thousands except share and per share data) continued****CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Prior to January 1, 2006, we accounted for our stock-based compensation plans in accordance with the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25) and related interpretations, as permitted by SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123). Accordingly, for restricted stock units granted, compensation expense was recognized in the consolidated statements of income prior to January 1, 2006 based on the market price of Avatar's common stock on the date the specified hurdle price was probable to be achieved, provided such provisions are applicable, or the date of grant. For stock options granted, no compensation expense was recognized in the consolidated statements of income prior to January 1, 2006 since all stock options granted had exercise prices greater than the market value of Avatar's stock on the grant date. Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123(R)) using the modified-prospective transition method. Under this transition method, compensation expense recognized during the six and three months ended June 30, 2006 included: (a) compensation expense for all share-based awards granted 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 expense for all share-based awards granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R). In accordance with the modified-prospective-transition method, results for prior periods have not been restated.

As of June 30, 2006, there was \$9,383 of unrecognized compensation expense related to unvested restricted stock units and unvested stock options, of which \$8,953 relates to restricted stock units and \$430 relates to stock options. That expense is expected to be recognized over a weighted-average period of 2.4 years.

The calculation of the fair values of our stock-based compensation plans requires estimates that require management's judgments. The fair value of each stock option is estimated on the grant date using the Black-Scholes option-pricing model. The fair value of restricted stock awards which contain a specified hurdle price condition is estimated on the grant date using the Monte-Carlo option valuation model (like a lattice model). The fair value of restricted stock awards which does not contain a specified hurdle price condition is based on the market price of our common stock on the date of grant. The valuation models require assumptions and estimates to determine expected volatility and risk-free interest rates. The expected volatility was determined using historical volatility of our stock based on the contractual life of the award. The risk-free interest rate assumption was based on the yield on zero-coupon U.S. Treasury strips at the award grant date. We also used historical data to estimate forfeiture experience.

There has been no other significant change to our critical accounting policies and estimates during the six months ended June 30, 2006 as compared to those we disclosed in Management's Discussion and Analysis of Financial Condition and Results of Operations included in Avatar's 2005 Annual Report on Form 10-K.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (dollars in thousands except share and per share data) continued

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN 48 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. The interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006, which is January 1, 2007 for us. We are currently evaluating the provisions of FIN 48 and assessing the impact it may have on our financial position and results of operations.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*, which replaces APB No. 20, *Accounting Changes* and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*. SFAS No. 154 retained accounting guidance related to changes in estimates, changes in a reporting entity and error corrections. The statement requires retrospective application of changes in an accounting principle to prior periods' financial statements unless it is impracticable to determine the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005, which was January 1, 2006 for us. The adoption of SFAS No. 154 did not have a material impact on our financial position or results of operations.

FORWARD LOOKING STATEMENTS

Certain statements discussed under the caption Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Form 10-Q constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause the actual results, performance or achievements of results, to differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements. Such risks, uncertainties and other important factors include, among others: the successful implementation of Avatar's business strategy; shifts in demographic trends affecting demand for active adult communities and other real estate development; the level of immigration and in-migration into the areas in which Avatar conducts real estate activities; international (in particular Latin America), national and local economic conditions and events, including employment levels, interest rates, consumer confidence, the availability of mortgage financing and demand for new and existing housing; access to future financing; geopolitical risks; competition; changes in, or the failure or inability to comply with, government regulations; adverse weather conditions and natural disasters; and other factors as are described in Avatar's filings with the Securities and Exchange Commission, including its Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

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Item 3. Quantitative and Qualitative Disclosure About Market Risk

There has been no material changes in Avatar's market risk during the six months ended June 30, 2006. For additional information regarding Avatar's market risk, refer to Item 7A, Quantitative and Qualitative Disclosures About Market Risk, in Avatar's 2005 Annual Report on Form 10-K.

Item 4. Controls and Procedures

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective for the purpose of ensuring that material information required to be in this report is made known to our management, including our Chief Executive Officer and Chief Financial Officer, and others, as appropriate, to allow timely decisions regarding required disclosures and are effective to provide reasonable assurance that such information is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we have determined that, during the fiscal quarter ended June 30, 2006, there were no changes in our internal control over financial reporting (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) that have affected, or are reasonably likely to affect, materially, our internal control over financial reporting.

Table of Contents**PART II OTHER INFORMATION****Item 2. Unregistered Sales of Equity Securities and Use of Proceeds (dollars in thousands except per share data)**

The following table represents shares repurchased by Avatar under the stock repurchase authorizations for the three months ended June 30, 2006:

| Period | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of a Publicly Announced Plan or Program (1) | Maximum Amount That May Yet Be Purchased Under the Plan or Program (1) |
|---------------------------------|--|--|--|---|
| April 1, 2006 to April 30, 2006 | | \$ | | \$ 15,829 |
| May 1, 2006 to May 31, 2006 | | | | \$ 15,829 |
| June 1, 2006 to June 30, 2006 | | | | \$ 15,829 |
| Total | | \$ | | |

(1) On March 20, 2003, Avatar's Board of Directors authorized the expenditure of up to \$30,000 to purchase, from time to time, shares of its common stock and/or 7% Convertible Subordinated Notes due April 2005 (the "7% Notes"), which were subsequently called for redemption, in the open market,

through privately negotiated transactions or otherwise, depending on market and business conditions and other factors.

On June 29, 2005, Avatar's Board of Directors amended the March 20, 2003 repurchase authorization to include the 4.50% Notes in addition to shares of its common stock.

As of June 30, 2006, the remaining authorization for purchase of shares of Avatar's common stock was \$15,829.

During the three months ended June 30, 2006, Avatar did not repurchase shares of its common stock and/or 4.50% Notes.

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

Avatar's Annual Meeting of Stockholders was held on May 25, 2006, in Coral Gables, Florida, for the purpose of electing eleven directors and approving the appointment of Ernst & Young LLP, independent registered public accounting firm, as auditors for the year ending December 31, 2006. Proxies were solicited from holders of 8,189,463 outstanding shares of Common Stock as of the close of business on March 31, 2006, as described in Avatar's Proxy Statement dated April 24, 2006. All of management's nominees for directors were elected and the appointment of Ernst & Young LLP was approved by the following votes:

Table of Contents**Item 4. Submission of Matters to a Vote of Security Holders** continued**ELECTION OF DIRECTORS**

| Name | Votes FOR | WITHHELD |
|--------------------|-----------|-----------|
| Eduardo A. Brea | 7,477,450 | 27,916 |
| Milton H. Dresner | 7,445,110 | 60,256 |
| Roger W. Einiger | 7,476,335 | 29,031 |
| Gerald Kelfer | 7,476,760 | 28,606 |
| Martin Meyerson | 7,364,611 | 140,755 |
| Joshua Nash | 7,479,614 | 25,752 |
| Kenneth T. Rosen | 7,477,408 | 27,958 |
| Joel M. Simon | 7,472,689 | 32,677 |
| Fred Stanton Smith | 7,474,661 | 30,705 |
| William G. Spears | 7,447,810 | 57,556 |
| Beth A. Stewart | 6,494,111 | 1,011,255 |

APPOINTMENT OF AUDITORS

| Shares Voted FOR | Shares Voted AGAINST | Shares ABSTAINED | Broker NON-VOTES |
|---------------------|-------------------------|---------------------|---------------------|
| 7,480,270 | 1,393 | 23,703 | 0 |

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Item 6. Exhibits

- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
- 32.1 Certification of Chief Executive Officer required by 18 U.S.C. Section 1350 (as adopted by Section 906 of the Sarbanes-Oxley Act of 2002) (furnished herewith).
- 32.2 Certification of Chief Financial Officer required by 18 U.S.C. Section 1350 (as adopted by Section 906 of the Sarbanes-Oxley Act of 2002) (furnished herewith).

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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.

AVATAR HOLDINGS INC.

Date: August 8, 2006

By: /s/ Charles L. McNairy

Charles L. McNairy
Executive Vice President, Treasurer and
Chief Financial Officer

Date: August 8, 2006

By: /s/ Michael P. Rama

Michael P. Rama
Controller and Chief Accounting Officer

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Exhibit Index

- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
- 32.1 Certification of Chief Executive Officer required by 18 U.S.C. Section 1350 (as adopted by Section 906 of the Sarbanes-Oxley Act of 2002) (furnished herewith).
- 32.2 Certification of Chief Financial Officer required by 18 U.S.C. Section 1350 (as adopted by Section 906 of the Sarbanes-Oxley Act of 2002) (furnished herewith).