AMERON INTERNATIONAL CORP
Form 10-Q
October 04, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

/X/ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)OF

THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 3, 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 No. 1 - 9102

AMERON INTERNATIONAL CORPORATION

(Exact name of registrant as specified in its charter)

DELAWARE	**77-0100596**
(State or other jurisdiction of	(I.R.S. Employer
incorporation or organization)	Identification No.)

245 South Los Robles Avenue
Pasadena, California 91101-3638
(Address of principal executive offices)

(626) 683-4000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes **/x/** No **/ /**

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer **/ /** Accelerated filer **/x/** Non-accelerated filer **/ /**

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

The number of outstanding shares of Common Stock, $2.50 par value, was 8,894,526 on September 3, 2006. No other class of Common Stock exists.

AMERON INTERNATIONAL CORPORATION

FORM 10-Q

For the Quarter Ended September 3, 2006

INDEX

			Page
Part I.	***Financial Information***		
	Item 1.	Consolidated Financial Statements	
		Consolidated Statements of Income	3
		Consolidated Balance Sheets	4
		Consolidated Statements of Cash Flows	5
		Notes to Consolidated Financial Statements	6
	Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	18
	Item 3.	Quantitative and Qualitative Market Risk Disclosures	24
	Item 4.	Controls and Procedures	24
Part II.	***Other Information***		
	Item 1.	Legal Proceedings	25
	Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	25
	Item 6.	Exhibits and Reports on Form 8-K	26
Signature Page			27
Certifications			

AMERON INTERNATIONAL CORPORATION AND SUBSIDIARIES

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(In thousands, except share and per share data)	Three Months Ended September 3, 2006	Three Months Ended August 28, 2005	Nine Months Ended September 3, 2006	Nine Months Ended August 28, 2005
Sales	$ 139,941	$ 136,555	$ 398,570	$ 355,560
Cost of Sales	(103,859)	(99,013)	(299,135)	(264,598)
Gross Profit	36,082	37,542	99,435	90,962
Selling, General and Administrative Expenses	(22,302)	(22,623)	(68,811)	(68,565)
Other Income, Net	1,458	239	10,822	895
Income from Continuing Operations before Interest, Income Taxes and Equity in Earnings of Joint Venture	15,238	15,158	41,446	23,292
Interest Expense, Net	(628)	(1,580)	(2,547)	(4,195)
Income from Continuing Operations before Income Taxes and Equity in Earnings of Joint Venture	14,610	13,578	38,899	19,097
Provision for Income Taxes	(2,538)	(5,109)	(10,450)	(6,875)
Income before Equity in Earnings of Joint Venture	12,072	8,469	28,449	12,222
Equity in Earnings of Joint Venture, Net of Taxes	4,910	3,119	9,493	6,235
Income from Continuing Operations	16,982	11,588	37,942	18,457
Income from Discontinued Operations, Net of Taxes	997	1,940	2,350	822
Net Income	$ 17,979	$ 13,528	$ 40,292	$ 19,279
Basic Earnings Per Share:				
Income from Continuing Operations	$ 1.94	$ 1.38	$ 4.37	$ 2.20
Income from Discontinued Operations, Net of Taxes	.11	.23	.27	.10
Net Income	$ 2.05	$ 1.61	$ 4.64	$ 2.30
Diluted Earnings Per Share:				
Income from Continuing Operations	$ 1.91	$ 1.35	$ 4.29	$ 2.16
Income from Discontinued Operations, Net of Taxes	.11	.23	.27	.10
Net Income	$ 2.02	$ 1.58	$ 4.56	$ 2.26
Weighted-Average Shares:				
Basic	8,748,617	8,409,746	8,677,515	8,372,408

Diluted	8,890,919	8,571,628	8,840,106	8,535,834
Cash Dividends per Share	$ .20	$ .20	$ .60	$ .60

See accompanying notes to consolidated financial statements.

AMERON INTERNATIONAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(In thousands, except share and per share data)	September 3, 2006	November 30, 2005
Assets		
Current Assets		
Cash and Cash Equivalents	$ 140,955	$ 44,671
Restricted Cash	9,001	-
Receivables, Less Allowances of $4,721 in 2006 and $7,693 in 2005	143,586	180,558
Inventories	81,177	98,389
Deferred Income Taxes	17,598	17,598
Prepaid Expenses and Other Current Assets	17,159	11,714
Total Current Assets	409,476	352,930
Investments in Joint Ventures		
Equity Method	17,085	13,777
Cost Method	3,784	5,922
Property, Plant and Equipment		
Land	33,154	38,959
Buildings	56,950	88,606
Machinery and Equipment	252,630	284,593
Construction in Progress	13,527	15,500
Total Property, Plant and Equipment at Cost	356,261	427,658
Accumulated Depreciation	(235,215)	(272,993)
Total Property, Plant and Equipment, Net	121,046	154,665
Deferred Income Taxes	-	143
Intangible Assets, Net of Accumulated Amortization of $2,982 in 2006 and $10,142 in 2005	2,180	13,259
Other Assets	50,217	37,340
Total Assets	$ 603,788	$ 578,036
Liabilities and Stockholders' Equity		
Current Liabilities		
Current Portion of Long-Term Debt	$ 10,000	$ 18,333
Trade Payables	39,755	54,349
Accrued Liabilities	67,598	63,071
Income Taxes Payable	8,868	1,051
Total Current Liabilities	126,221	136,804
Long-Term Debt, Less Current Portion	85,807	77,109
Other Long-Term Liabilities	54,188	67,625
Total Liabilities	266,216	281,538
Stockholders' Equity		
Common Stock, Par Value $2.50 per Share, Authorized 24,000,000 Shares, Outstanding 8,894,526 Shares in 2006 and 8,698,148 Shares in 2005, Net of Treasury Shares	28,994	28,450
Additional Paid-In Capital	33,158	28,936

Unearned Restricted Stock	-	(2,084)
Retained Earnings	361,801	326,795
Accumulated Other Comprehensive Loss	(35,903)	(36,324)
Treasury Stock (2,703,148 Shares in 2006 and 2,681,811 Shares in 2005)	(50,478)	(49,275)
Total Stockholders' Equity	337,572	296,498
Total Liabilities and Stockholders' Equity	$ 603,788	$ 578,036

See accompanying notes to consolidated financial statements.

AMERON INTERNATIONAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(In Thousands)	Nine Months Ended September 3, 2006	Nine Months Ended August 28, 2005
Cash Flows from Operating Activities		
Net Income	$ 40,292	$ 19,279
Adjustments to Reconcile Net Income to Net Cash Provided by/(Used in) Operating Activities:		
Depreciation	13,894	14,127
Amortization	134	157
Provision/(Benefit) for Deferred Income Taxes	(38)	189
Net Earnings and Distributions from Joint Ventures	(3,308)	73
Gain from Sale of Discontinued Operations	(215)	-
Gain from Sale of Other Assets	(9,118)	(1,400)
Stock Compensation Expense	2,829	1,243
Changes in Operating Assets and Liabilities, Net of Effects of Dispositions:		
Receivables	(6,926)	(29,484)
Inventories	(30,737)	(17,512)
Prepaid Expenses and Other Current Assets	(7,126)	(2,001)
Other Assets	457	(3,944)
Trade Payables	1,459	3,228
Accrued Liabilities and Income Taxes Payable	18,660	5,004
Other Long-Term Liabilities	(17,863)	3,036
Net Cash Provided by/(Used in) Operating Activities	2,394	(8,005)
Cash Flows from Investing Activities		
Proceeds from Sale of Discontinued Operations	115,000	-
Proceeds from Sale of Other Assets	590	2,389
Additions to Property, Plant and Equipment	(18,128)	(17,402)
Net Cash Provided by/(Used in) Investing Activities	97,462	(15,013)
Cash Flows from Financing Activities		
Issuance of Debt	6,670	25,676
Repayment of Debt	(8,862)	(8,318)
Dividends on Common Stock	(5,286)	(5,089)
Issuance of Common Stock	4,186	1,834
Change in Treasury Stock	(1,203)	(501)
Net Cash (Used in)/Provided by Financing Activities	(4,495)	13,602
Effect of Exchange Rate Changes on Cash and Cash Equivalents	923	(276)

Net Change in Cash and Cash Equivalents		96,284		(9,692)
Cash and Cash Equivalents at Beginning of Period		44,671		30,124
Cash and Cash Equivalents at End of Period	$	140,955	$	20,432

See accompanying notes to consolidated financial statements.

AMERON INTERNATIONAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in Thousands, Except Per Share Data)

(Unaudited)

Note 1. Basis of Presentation

Consolidated financial statements for the interim periods included herein are unaudited; however, they contain all adjustments, including normal recurring accruals, which in the opinion of management, are necessary to present fairly the consolidated financial position of Ameron International Corporation and all wholly-owned subsidiaries (the "Company" or "Ameron" or the "Registrant") as of September 3, 2006, and consolidated results of operations and cash flows for the three and nine months ended September 3, 2006 and August 28, 2005. Accounting measurements at interim dates inherently involve greater reliance on estimates than at year-end. Results of operations for the periods presented are not necessarily indicative of the results to be expected for the full year.

For accounting consistency, the quarter ends on the Sunday before or after the end of the relevant calendar month, such that each quarter consists of approximately 13 full weeks. Ameron's fiscal year ends on November 30, regardless of the day of the week. The number of days per quarter can change from period to period.

The consolidated financial statements do not include certain footnote disclosures and financial information normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America and, therefore, should be read in conjunction with the consolidated financial statements and notes included in Ameron's Annual Report on Form 10-K for the year ended November 30, 2005 ("2005 Annual Report").

Note 2. New Accounting Pronouncements

In May 2005, the Financial Accounting Standards Board ("FASB") issued Statements of Financial Accounting Standards ("SFAS") No. 154, *Accounting Changes and Error Corrections--A Replacement of APB Opinion No. 20 and FASB Statement No. 3*. SFAS No. 154 requires retrospective application to prior periods' financial statements for changes in accounting principles, unless it is impracticable to determine either the period-specific effects or the cumulative effects of the changes. SFAS No. 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle, such as a change in non-discretionary profit-sharing payments resulting from an accounting change, should be recognized in the period of the accounting change. SFAS No. 154 also requires that a change in depreciation, amortization, or depletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate affected by a change in accounting principle. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Early adoption is permitted for accounting changes and corrections of errors made in fiscal years beginning after the date SFAS No. 154 was issued. The Company is required to adopt the provisions of SFAS No. 154, as applicable, beginning in fiscal year 2007. Management does not believe the adoption of SFAS No. 154 will have a material impact on the Company's financial position or results of operations.

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments*. SFAS No. 155 amends FASB Statement No. 133 and FASB Statement No. 140, and improves the financial reporting of certain hybrid financial instruments by requiring more consistent accounting that eliminates exemptions and provides a means to simplify the accounting for these instruments. Specifically, SFAS No. 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company is required to adopt the provisions of SFAS No. 155, as applicable, beginning in fiscal year 2007. Management does not believe the adoption of SFAS No. 155 will have a material impact on the Company's financial position or results of operations.

In June 2006, the FASB issued Interpretation No. ("FIN") 48, *Accounting for Uncertainty in Income Taxes*. This interpretation of FASB Statement No. 109, *Accounting for Income Taxes*, prescribes a recognition threshold or measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. In order to minimize the diversity in practice existing in the accounting for income taxes, FIN 48 also provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 shall be effective for fiscal years beginning after December 15, 2006. The Company is required to adopt the provisions of FIN 48 beginning in fiscal year 2008. Management does not believe the adoption of FIN 48 will have a material impact on the Company's financial position or results of operations.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is required to adopt the provision of SFAS No. 157, as applicable, beginning in fiscal year 2008. Management does not believe the adoption of SFAS No. 157 will have a material impact on the Company's financial position or results of operations.

AMERON INTERNATIONAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 3. Discontinued Operations

On August 1, 2006, the Company completed the sale of its Performance Coatings & Finishes business (the "Coatings Business") to PPG Industries, Inc. ("PPG") for $115,000 in cash upon the closing, plus an adjustment based on the net asset value of transferred assets and liabilities at closing, which is estimated to total $14,600. Certain assets were excluded from the sale, including cash and cash equivalents and certain real properties that were used in the Coatings Business. Ameron intends to sell the retained properties in the next 12 to 18 months and expects to generate additional proceeds of approximately $15,000 based on current estimates of market values.

	Three Months Ended		Nine Months Ended	
	September 3, 2006	August 28, 2005	September 3, 2006	August 28, 2005
Revenue from Discontinued Operations	$ 41,828	$ 56,492	$ 152,190	$ 152,504
Income from Discontinued Operations, Before Disposal, Before Income Taxes	$ 2,187	$ 3,843	$ 5,202	$ 2,643
Income Taxes on Income from Discontinued Operations	(1,405)	(1,903)	(3,067)	(1,821)
Income from Discontinued Operations, Before Disposal, Net of Taxes	782	1,940	2,135	822
Gain from Sale of Discontinued Operations, Before Income Taxes	1,162	-	1,162	-
Income Taxes on Gain from Sale of Discontinued Operations	(947)	-	(947)	-
Gain on Sale of Discontinued Operations, Net of Taxes	215	-	215	-
Income from Discontinued Operations, Net of Taxes	$ 997	$ 1,940	$ 2,350	$ 822

Note 4. Restricted Cash

Restricted cash consisted of net proceeds of $9,001 from the sale of property in Brea, California that were transferred directly to a trust fund established for a potential tax-free exchange under Internal Revenue Code Section 1031.

Note 5. Inventories

Inventories are stated at the lower of cost or market. Inventories consisted of the following:

	September 3, 2006	November 30, 2005
Finished Products	$ 26,325	$ 54,661
Materials and Supplies	18,166	23,636
Products in Process	36,686	20,092
	$ 81,177	$ 98,389

Note 6. Supplemental Disclosure of Cash Flow Information

	Nine Months Ended	
	September 3, 2006	August 28, 2005
Interest Paid	$ 3,452	$ 3,210
Income Taxes Paid	$ 6,624	$ 10,222
Restricted Cash (see Note 4)	$ 9,001	$ -

AMERON INTERNATIONAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 7. Joint Ventures

Operating results of TAMCO, an investment which is accounted for under the equity method, were as follows:

	Three Months Ended		Nine Months Ended	
	September 3, 2006	August 28, 2005	September 3, 2006	August 28, 2005
Net Sales	$ 69,521	$ 72,398	$ 193,293	$ 186,278
Gross Profit	$ 21,258	$ 13,939	$ 43,353	$ 30,118
Net Income	$ 10,960	$ 6,877	$ 21,191	$ 14,036

Investments in Ameron Saudi Arabia, Ltd. ("ASAL") and Bondstrand, Ltd. ("BL") are accounted for under the cost method due to management's current assessment of the Company's influence over these joint ventures. The rights and rewards of the investment in Oasis-Ameron, Ltd. ("OAL") were transferred to PPG as part of the sale of the Coatings Business on August 1, 2006.

Earnings and dividends from the Company's joint ventures were as follows:

	Three Months Ended		Nine Months Ended	
	September 3, 2006	August 28, 2005	September 3, 2006	August 28, 2005
Earnings from Joint Ventures				
TAMCO	$ 5,480	$ 3,438	$ 10,596	$ 6,874
Dividends Received from Joint Ventures				
TAMCO	$ 2,998	$ 2,613	$ 7,288	$ 6,947
ASAL	-	-	-	-
BL	-	-	-	-

Earnings from ASAL and BL, if any, are included in other income.

AMERON INTERNATIONAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 8. Net Income Per Share

Basic net income per share is computed on the basis of the weighted-average number of common shares outstanding during the periods presented. Diluted net income per share is computed on the basis of the weighted-average number of common shares outstanding, plus the effect of outstanding stock options and restricted shares, using the treasury stock method. All outstanding common stock equivalents, consisting of restricted shares of 98,002 and 99,834, and options to purchase 396,883 and 677,351 common shares, were dilutive for the three and nine months ended September 3, 2006 and August 28, 2005, respectively. Following is a reconciliation of the weighted-average number of shares used in the computation of basic and diluted net income per share:

	Three Months Ended		Nine Months Ended	
	September 3, 2006	August 28, 2005	September 3, 2006	August 28, 2005
Numerator:				
Income from continuing operations	$ 16,982	$ 11,588	$ 37,942	$ 18,457
Income from discontinued operations, net of taxes	997	1,940	2,350	822
Net income	$ 17,979	$ 13,528	$ 40,292	$ 19,279
Denominator for basic income per share:				
Weighted-average shares outstanding, basic	8,748,617	8,409,746	8,677,515	8,372,408
Denominator for diluted income per share:				
Weighted-average shares outstanding, basic	8,748,617	8,409,746	8,677,515	8,372,408
Dilutive effect of stock options and restricted shares	142,302	161,882	162,591	163,426
Weighted-average shares outstanding, diluted	8,890,919	8,571,628	8,840,106	8,535,834
Basic net income per share:				
Income from continuing operations	$ 1.94	$ 1.38	$ 4.37	$ 2.20
Income from discontinued operations, net of taxes	.11	.23	.27	.10
Net income	$ 2.05	$ 1.61	$ 4.64	$ 2.30
Diluted net income per share:				
Income from continuing operations	$ 1.91	$ 1.35	$ 4.29	$ 2.16
Income from discontinued operations, net of taxes	.11	.23	.27	.10
Net income	$ 2.02	$ 1.58	$ 4.56	$ 2.26

Note 9. Comprehensive Income

Comprehensive income was as follows:

	Three Months Ended		Nine Months Ended	
	September 3, 2006	August 28, 2005	September 3, 2006	August 28, 2005
Net Income	$ 17,979	$ 13,528	$ 40,292	$ 19,279
Foreign Currency Translation Adjustment	(4,066)	(1,887)	421	(5,944)
Comprehensive Income from Joint Venture	-	113	-	34
Comprehensive Income	$ 13,913	$ 11,754	$ 40,713	$ 13,369

AMERON INTERNATIONAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note 10. Debt

The Company's long-term debt consisted of the following:

	September 3, 2006	November 30, 2005
Fixed-rate notes:		
7.92% senior notes	$ -	$ 8,333
5.36% senior notes, payable in annual principal installments of $10,000, maturing in November 2009	40,000	40,000
4.25% senior notes, payable in Singapore Dollars, in annual principal installments of $6,488, commencing in 2008, maturing in November 2012	32,438	30,158
Variable-rate industrial development bonds:		
Maturing in 2016 (3.80% at September 3, 2006)	7,200	7,200
Maturing in 2021 (3.80% at September 3, 2006)	8,500	8,500
Variable-rate bank revolving credit facilities:		
Foreign, maturing in September 2010 (3.95% at September 3, 2006)	7,669	1,251
Total long-term debt	95,807	95,442
Less current portion	(10,000)	(18,333)
Long-term debt, less current portion	$ 85,807	$ 77,109

The Company maintains a $100,000 revolving credit facility with six banks (the "Revolver"). Under the Revolver, the Company may, at its option, borrow at floating interest rates (LIBOR plus a spread ranging from .75% to 1.625% determined by the Company's financial condition and performance), at any time until September 2010, when all borrowings under the Revolver must be repaid. The lending agreements contain various restrictive covenants, including the requirement to maintain specified amounts of net worth and restrictions on cash dividends, borrowings, liens, investments, guarantees, and financial covenants. The Company was in compliance with all covenants as of September 3, 2006. The Revolver, the 4.25% term notes and the 5.36% term notes are collateralized by a substantial portion of the Company's assets. The industrial revenue bonds are supported by standby letters of credit that are issued under the Revolver. The interest rate on the industrial development bonds is based on a weekly index of tax exempt issues plus a spread of .20%. Certain note agreements contain provisions regarding the Company's ability to grant security interests or liens in association with other debt instruments. If the Company grants such a security interest or lien, then such notes will be collateralized equally and ratably as long as such other debt shall be collateralized.

Borrowings under certain bank facilities by the Company and its foreign subsidiaries are supported by the Revolver and, accordingly, have been classified as long-term debt and are considered payable when the Revolver is due.

Note 11. Segment Information

The Company provides certain information about operating segments in accordance with SFAS No. 131, *Disclosure about Segments of an Enterprise and Related Information*. In accordance with SFAS No. 131, the Company has determined that it has four operating and three reportable segments: Fiberglass-Composite Pipe, Water Transmission and Infrastructure Products. Infrastructure Products consists of two operating segments, the Pole Products and Hawaii Divisions, which are aggregated. In the prior periods, the Company included a fourth reportable segment, Performance Coatings & Finishes, which was sold effective August 1, 2006. The results from this segment have been reported as discontinued operations for all reporting periods. Each of the segments has a dedicated management team and is managed separately, primarily because of differences in products. The Company's Chief Operating Decision Maker is the Chief Executive Officer who primarily reviews sales and income before interest, income taxes and equity in earnings of joint venture for each operating segment in making decisions about allocating resources and assessing performance. The Company allocates certain selling, general and administrative expenses to operating segments utilizing assumptions believed to be appropriate in the circumstances. Costs of shared services (e.g., costs of Company-wide insurance programs or benefit plans) are allocated to the operating segments based on revenue, wages or net assets employed. Other items not related to current operations or of an unusual nature, such as adjustments to reflect inventory balances of certain steel inventories under the last-in, first-out ("LIFO") method, certain unusual legal costs and expenses, interest expense and income taxes, are not allocated to the reportable segments.

AMERON INTERNATIONAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Following is information related to each reportable segment included in, and in a manner consistent with, internal management reports:

	Three Months Ended		Nine Months Ended	
	September 3, 2006	August 28, 2005	September 3, 2006	August 28, 2005
Sales				
Fiberglass-Composite Pipe	$ 48,477	$ 37,394	$ 131,326	$ 96,159
Water Transmission	36,999	55,716	118,086	136,779
Infrastructure Products	54,580	43,618	149,857	122,947
Eliminations	(115)	(173)	(699)	(325)
Total Sales	$ 139,941	$ 136,555	$ 398,570	$ 355,560
Income from Continuing Operations Before Interest, Income Taxes and Equity in Earnings of Joint Venture				
Fiberglass-Composite Pipe	$ 10,850	$ 6,166	$ 26,746	$ 16,121
Water Transmission	668	9,923	4,099	19,236
Infrastructure Products	9,063	6,222	23,442	15,198
Corporate & Unallocated	(5,343)	(7,153)	(12,841)	(27,263)
Total Income from Continuing Operations before Interest, Income Taxes				

and Equity in Earnings of Joint Venture	$ 15,238	$ 15,158	$ 41,446	$ 23,292

	September 3, 2006		November 30, 2005	
Assets				
Fiberglass-Composite Pipe	$	204,846	$	176,713
Water Transmission		139,674		132,803
Infrastructure Products		103,216		83,053
Corporate & Unallocated		289,633		162,979
Discontinued Operations		-		170,784
Eliminations		(133,581)		(148,296)
Total Assets	$	603,788	$	578,036

Note 12. Commitments & Contingencies

The Company is one of numerous defendants in various asbestos-related personal injury lawsuits. These cases generally seek unspecified damages for asbestos-related diseases based on alleged exposure to products previously manufactured by the Company and others, and at this time the Company is generally not aware of the extent of injuries allegedly suffered by the individuals or the facts supporting the claim that injuries were caused by the Company's products. Based upon the information available to it at this time, the Company is not in a position to evaluate its potential exposure, if any, as a result of such claims or future similar claims, if any, that may be filed. Hence, no amounts have been accrued for loss contingencies related to these lawsuits in accordance with SFAS No. 5, *Accounting for Contingencies*. The Company continues to vigorously defend all such lawsuits. As of September 3, 2006, the Company was a defendant in asbestos-related cases involving 149 claimants, compared to 924 claimants as of June 4, 2006. The Company is not in a position to estimate the number of additional claims that may be filed against it in the future. For the quarter ended September 3, 2006, there were six new claimants, dismissals and/or settlements involving 781 claimants, and no judgments. Net costs and expenses incurred by the Company during the quarter ended September 3, 2006 in connection with asbestos-related claims were less than $100.

The Company is one of numerous defendants in various silica-related personal injury lawsuits. These cases generally seek unspecified damages for silica-related diseases based on alleged exposure to products previously manufactured by the Company and others, and at this time the Company is not aware of the extent of injuries allegedly suffered by the individuals or the facts supporting the claim that injuries were caused by the Company's products. Based upon the information available to it at this time, the Company is not in a position to evaluate its potential exposure, if any, as a result of such claims or future similar claims, if any, that may be filed. Hence, no amounts have been

---

accrued for loss contingencies related to these lawsuits in accordance with SFAS No. 5. The Company continues to vigorously defend all such lawsuits. As of September 3, 2006, the Company was a defendant in silica-related cases involving 129 claimants, compared to 241 claimants as of June 4, 2006. The Company is not in a position to estimate the number of additional claims that may be filed against it in the future. For the quarter ended September 3, 2006, there were no new claimants, dismissals and/or settlements involving 112 claimants, and no judgments. Net costs and expenses incurred by the Company during the quarter ended September 3, 2006 in connection with silica-related claims were less than $200.

In April 2003, the Company was served with a complaint in an action brought by J. Ray McDermott, Inc., J. Ray McDermott, S.A. and SparTEC, Inc. (collectively "McDermott") in the District Court of Harris County, Texas against the Company and two co-defendants, in connection with certain coatings supplied by the defendants in 2002 for an offshore production facility known as a SPAR being constructed by McDermott for Dominion Exploration and Production, Inc. and Pioneer Natural Resources USA, Inc. (collectively "Dominion"). The Company reached a settlement with McDermott in May 2005. Legal costs and expenses related to this suit totaled $4,900 in the nine months ended August 28, 2005. In May 2003, Dominion brought a separate action against the Company in Civil District Court for the Parish of Orleans, Louisiana as owners of the SPAR seeking damages allegedly sustained by Dominion resulting from delays in McDermott's delivery of the SPAR caused by the removal and replacement of coatings containing lead and/or lead chromate. Dominion contends that the Company made certain misrepresentations and warranties to Dominion concerning the lead-free nature of those coatings. Dominion's petition as filed alleged a claim for damages in an unspecified amount; however, Dominion's economic expert subsequently estimated Dominion's damages at approximately $128,000, a figure which the Company vigorously contests. This matter is in discovery and no trial date has yet been established. The Company believes that it has meritorious defenses to this action. Based upon the information available to it at this time, the Company is not in a position to evaluate the ultimate outcome of this matter; and no amounts have been accrued for a loss contingency related to this lawsuit.

In April 2004, Sable Offshore Energy Inc. ("Sable"), as agent for certain owners of the Sable Offshore Energy Project, brought an action against various coatings suppliers and application contractors, including the Company and two of its subsidiaries, Ameron (UK) Limited and Ameron B.V. (collectively "Ameron Subsidiaries") in the Supreme Court of Nova Scotia, Canada. Sable seeks damages allegedly sustained by it resulting from performance problems with several coating systems used on the Sable Offshore Energy Project, including coatings products furnished by the Company and the Ameron Subsidiaries. Sable's originating notice and statement of claim alleged a claim for damages in an unspecified amount; however, Sable has since alleged that its claim for damages against all defendants is approximately 428,000 Canadian dollars, a figure which the Company and the Ameron Subsidiaries vigorously contest. This matter is in discovery, and no trial date has yet been established. The Company believes that it has meritorious defenses to this action. Based upon the information available to it at this time, the Company is not in a position to evaluate the ultimate outcome of this matter.

In addition, certain other claims, suits and complaints that arise in the ordinary course of business, have been filed or are pending against the Company. While the outcome of these matters cannot be predicted with certainty, based on the information currently available, management believes that these matters are either adequately reserved, covered by insurance, or would not have a material effect on the Company's financial position, results of operations, or cash flow if disposed of unfavorably.

The Company is subject to federal, state and local laws and regulations concerning the environment and is currently participating in administrative proceedings at several sites under these laws. While the Company finds it difficult to estimate with any certainty the total cost of remediation at the several sites, on the basis of currently available information and reserves provided, the Company believes that the outcome of such environmental regulatory proceedings will not have a material effect on the Company's financial position, results of operations, or cash flows.

Note 13. Product Warranties and Guarantees

The Company's product warranty accrual reflects management's estimate of probable liability associated with product warranties. Management establishes product warranty accruals based on historical experience and other currently available information.

Changes in the product warranty accrual were as follows:

	Nine Months Ended	
	September 3, 2006	August 28, 2005
Balance, Beginning of Period	$ 4,026	$ 4,297
Charges	(599)	(2,737)
Warranty Accruals During the Period	1,456	2,427
Warranties Extinguished Upon Sale of Discontinued Operations	(1,969)	-
Balance, End of Period	$ 2,914	$ 3,987

Note 14. Goodwill and Other Intangible Assets

Changes in the Company's carrying amount of goodwill by business segment were as follows:

Segment	November 30, 2005	Acquisition / (Disposition)	Foreign Currency Translation Adjustments	September 3, 2006
Continuing Operations:				
Fiberglass-Composite Pipe	$ 1,440	$ -	$ -	$ 1,440
Water Transmission	-	392	-	392
Infrastructure Products	201	-	-	201
Total	$ 1,641	$ 392	$ -	$ 2,033
Discontinued Operations:				
Performance Coatings & Finishes	$ 11,441	$ (11,578)	$ 137	$ -

The goodwill of $392 is related to the acquisition of a steel fabrication operation in Mexico by the Water Transmission Group in 2006. Also in 2006, the Company sold the Coatings Business.

The Company's intangible assets, other than goodwill, and related accumulated amortization consisted of the following:

	September 3, 2006		November 30, 2005	
	Gross Intangible Assets	Accumulated Amortization	Gross Intangible Assets	Accumulated Amortization
Continuing Operations:				
Trademarks	$ 100	$ (100)	$ 100	$ (100)
Non-compete Agreements	252	(105)	105	(105)
Patents	212	(212)	212	(212)
Leasehold Interests	1,930	(1,930)	1,930	(1,930)
Total	$ 2,494	$ (2,347)	$ 2,347	$ (2,347)
Discontinued Operations:				
Trademarks	$ -	$ -	$ 2,019	$ (1,962)
Non-compete Agreements	-	-	2,000	(1,880)
Total	$ -	$ -	$ 4,019	$ (3,842)

All of the Company's intangible assets, other than goodwill, are subject to amortization. Amortization expense for the three months and nine months ended September 3, 2006 was $35 and $134, respectively. Amortization expense for the three months and nine months ended August 28, 2005 was $52 and $157, respectively. All of these expenses related to the Coatings Business. At September 3, 2006, estimated future amortization expenses, which related to the Water Transmission Group, were: $35 for the remaining three months of 2006, $24 for 2007, $24 for 2008, $24 for 2009, $24 for 2010, and $16 for 2011.

Note 15. Stock-Based Compensation

As of September 3, 2006, the Company had outstanding grants under the following share-based compensation plans:

- 1992 Incentive Stock Compensation Plan ("1992 Plan") - The 1992 Plan was terminated in 2001, except as to the outstanding options. 500,000 new shares of common stock were made available for awards to key employees. Key employees were granted options to purchase the Company's common stock at prices not less than 100% of market value on the date of grant. Such options vested in equal annual installments over four years and terminate fifteen years from the dates of grant.

- 1994 Non-Employee Director Stock Option Plan ("1994 Plan") - The 1994 Plan was terminated in 2001, except as to the outstanding options. 240,000 new shares of common stock were made available for awards to non-employee directors. Non-employee directors were granted options to purchase the Company's common stock at prices not less than 100% of market value on the date of grant. Such options vested in equal annual installments over four years and terminate ten years from the dates of grant.

- 2001 Stock Incentive Plan ("2001 Plan") - The 2001 Plan was terminated in 2004, except as to the outstanding stock options and restricted stock grants. 380,000 new shares of common stock were made available for awards to key employees and non-employee directors. The 2001 Plan served as the successor to both 1992 Plan and 1994 Plan and superseded those plans. Non-employee directors were granted options under the 2001 Plan to purchase the Company's common stock at prices not less than 100% of market value on the date of grant. Such options vested in equal annual installments over four years. Such options terminate ten years from the date of grant. Key employees were granted restricted stock under the 2001 Plan. Such restricted stock grants vested in equal annual installments over four years.
- 2004 Stock Incentive Plan ("2004 Plan") - The 2004 Plan serves as the successor to the 2001 Plan and supersedes that plan. 525,000 new shares of common stock were made available for awards to key employees and non-employee directors and may include, but are not limited to, stock options and restricted stock grants. Non-employee directors were granted options under the 2004 Plan to purchase the Company's common stock at prices not less than 100% of market value on the date of grant. Such options vest in equal annual installments over four years and terminate ten years from the date of grant. Key employees were granted restricted stock under the 2004 Plan. Such restricted stock grants vest in equal annual installments over three years. During the nine months ended September 3, 2006, the Company granted 45,000 restricted shares to key employees with fair value of $2,461 and 6,000 restricted shares to non-employee directors with fair value of $360.

In addition to the above, on January 24, 2001, non-employee directors were granted options to purchase the Company's common stock at prices not less than 100% of market value on the dates of grant. Such options vested in equal annual installments over four years and terminate ten years from the date of grant. At September 3, 2006, there were 30,000 shares subject to such stock options.

Prior to December 1, 2005, the company applied Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for its various stock option plans. Effective December 1, 2005, the Company adopted SFAS No. 123 (revised 2004), *Share-Based Payments*, using the Modified Prospective Application method. SFAS No. 123 (R) requires the Company to measure all employee stock-based compensation awards using the fair-value method and to record such expense in its consolidated financial

statements. Under the Modified Prospective Application method, financial results for the prior period have not been adjusted. Stock-based compensation expense for the three and nine months ended September 3, 2006 includes: (a) compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of December 1, 2005, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, and (b) compensation expense for all stock-based compensation awards granted subsequent to November 30, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123 (R).

As a result of adopting SFAS No. 123 (R), the Company's income from continuing operations before income taxes and equity in earnings of joint venture for the three and nine months ended September 3, 2006 included compensation expense of $446 and $2,829, respectively, related to stock-based compensation arrangements. There were no capitalized share-based compensation costs for the three and nine months ended September 3, 2006.

Prior to the adoption of SFAS No. 123 (R), the Company reported all tax benefits resulting from the exercise of stock options as operating cash flows in its consolidated statements of cash flows. In accordance with SFAS No. 123 (R), the Company will present excess tax benefits from the exercise of stock options as financing cash flows. For the three and nine months ended September 3, 2006, no excess tax benefits were reported as financing cash flows.

AMERON INTERNATIONAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table illustrates the effect on net income and earnings per share as if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based compensation for the three and nine months ended August 28, 2005:

Prior Year Stock-Based Compensation

	Three Months Ended August 28, 2005	Nine Months Ended August 28, 2005
Reported Net Income	$ 13,528	$ 19,279
Add: Stock-based Employee Compensation Expense Included in Reported Net Income, Net of Tax	636	746
Deduct: Stock-based Employee Compensation Expense Determined under SFAS No. 123, Net of Tax	(316)	(804)
Pro Forma Net Income	$ 13,848	$ 19,221
Basic Net Income Per Share:		
As Reported	$ 1.61	$ 2.30
Pro Forma	$ 1.65	$ 2.30
Diluted Net Income Per Share:		
As Reported	$ 1.58	$ 2.26
Pro Forma	$ 1.62	$ 2.25

The following table summarizes the stock option activity for the periods presented below:

Current Year Stock-Based Compensation

Options	Number of Options	Weighted-Average Exercise Price per Share	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding at November 30, 2005	467,783	$ 24.11		
Exercised	(11,000)	19.30		
Outstanding at March 5, 2006	456,783	24.22	5.91	$ 17,169
Exercised	(59,900)	19.87		
Outstanding at June 4, 2006	396,883	24.87	5.87	$ 13,317

Exercised	(95,815)	27.26			
Outstanding at September 3, 2006	301,068	24.10	5.41	$	13,882
Options exercisable at September 3, 2006	274,068	23.26	5.17	$	12,867

For the three and nine months ended September 3, 2006, no options were granted, were forfeited or expired. For the three months ended August 28, 2005, no options were granted. The weighted-average grant-date fair value of options granted for the nine months ended August 28, 2005 was $33.28. For the three months ended September 3, 2006 and August 28, 2005, no restricted stock was granted or vested. The weighted-average grant-date fair value of restricted stock granted for the nine months ended September 3, 2006 and August 28, 2005 was $55.31 and $36.20, respectively. The fair value of restricted stock vested for the nine months ended September 3, 2006 and August 28, 2005 was $2,969 and $1,278, respectively.

AMERON INTERNATIONAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The aggregate intrinsic value in the table above represents the total pretax intrinsic value, which is the difference between the Company's closing stock price on the last trading day of the third quarter of 2006 and the exercise price times the number of shares that would have been received by the option holders if they had exercised their options on September 3, 2006. This amount will change based on the fair market value of the Company's stock. The aggregate intrinsic value of stock options exercised for the three and nine months ended September 3, 2006 was $2,624 and $5,786, respectively. The aggregate intrinsic value of stock options exercised for the three and nine months ended August 28, 2005 was $1,406 and $1,558, respectively. As of September 3, 2006, unrecognized compensation cost related to stock-based compensation arrangements totaled $2,398. That cost is expected to be recognized over a weighted-average period of 2.4 years.

Net cash proceeds from stock option exercises for the three and nine months ended September 3, 2006 was $2,777 and $4,186, respectively. Net cash proceeds from stock option exercises for the three and nine months ended August 28, 2005 was $1,678 and $1,834, respectively. The Company's policy is to issue shares from its authorized shares upon the exercise of stock options.

Note 16. Employee Benefit Plans

For the three and nine months ended September 3, 2006 and August 28, 2005, net pension and postretirement costs were composed of the following:

Employee Benefits (Three Months)

	Pension Benefits					
	U.S. Plans		Non U.S. Plans		U.S. Postretirement Benefits	
	Three Months Ended September 3 and August 28,					
	2006	2005	2006	2005	2006	2005
Service Cost	$ 814	$ 781	$ 283	$ 334	$ 20	$ 30
Interest Cost	2,548	2,519	458	463	45	51
Expected Return on Plan Assets	(3,053)	(2,801)	(341)	(346)	(7)	(8)
Amortization of Unrecognized Prior Service Cost	24	25	125	164	(4)	(4)
Amortization of Unrecognized Net Transition Obligation	-	-	-	-	12	18
Amortization of Accumulated Loss	1,108	1,239	81	19	10	15
Curtailment	57	-	2,990	-	-	-
Special Plan Termination Benefit	268	-	-	-	-	-
Net Periodic Cost	$ 1,766	$ 1,763	$ 3,596	$ 634	$ 76	$ 102

Employee Benefits (Nine Months)

	Nine Months Ended September 3 and August 28,					
	2006	2005	2006	2005	2006	2005
Service Cost	$ 2,441	$ 2,343	$ 849	$ 1,001	$ 60	$ 89
Interest Cost	7,645	7,557	1,375	1,388	135	153
Expected Return on Plan Assets	(9,158)	(8,403)	(1,022)	(1,037)	(21)	(23)
Amortization of Unrecognized Prior Service Cost	72	75	376	492	(12)	(11)
Amortization of Unrecognized Net Transition Obligation	-	-	-	-	36	53
Amortization of Accumulated Loss	3,325	3,717	244	57	30	44
Curtailment	57	-	2,990	-	-	-
Special Plan Termination Benefit	268	-	-	-	-	-
Net Periodic Cost	$ 4,650	$ 5,289	$ 4,812	$ 1,901	$ 228	$ 305

AMERON INTERNATIONAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The Company's U.S. and Non-U.S. benefit plans have been modified as a result of the sale of the Coatings Business on August 1, 2006. The modifications included curtailment costs of $57 in the U.S. Plans and $2,990 in the Non U.S. Plans, and $268 in special plan termination benefits under the U.S. Plans.

The Company's policy is to make pension plan contributions to the extent such contributions are mandatory, actuarially determined, and tax deductible. The Company contributed $21,599 to the U.S. pension plan in the first nine months of 2006. The Company contributed $863 to the non-U.S. pension plan for the first nine months of 2006 and expects to contribute $272 for the remainder of fiscal 2006.

AMERON INTERNATIONAL CORPORATION AND SUBSIDIARIES

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

INTRODUCTION

Ameron International Corporation ("Ameron" or the "Company") is a multinational manufacturer of highly-engineered products and materials for the chemical, industrial, energy, transportation and infrastructure markets. Ameron is a leading producer of water transmission lines; fiberglass-composite pipe for transporting oil, chemicals and corrosive fluids and specialized materials and products used in infrastructure projects. The Company operates businesses in North America, South America, Europe and Asia. The Company has three reportable segments. The Fiberglass-Composite Pipe Group manufactures and markets filament-wound and molded composite fiberglass pipe, tubing, fittings and well screens. The Water Transmission Group manufactures and supplies concrete and steel pressure pipe, concrete non-pressure pipe, protective linings for pipe, and fabricated steel products. The Infrastructure Products Group consists of two operating segments, which are aggregated: the Hawaii Division which manufactures and sells ready-mix concrete, sand and aggregates, concrete pipe and culverts and the Pole Products Division which manufactures and sells concrete and steel lighting and traffic poles. The markets served by the Fiberglass-Composite Pipe Group are worldwide in scope. The Water Transmission Group serves primarily the western U.S. The Infrastructure Products Group's quarry and ready-mix business operates exclusively in Hawaii, and poles are sold throughout the U.S. Ameron also participates in several joint-venture companies, directly in the U.S. and Saudi Arabia, and indirectly in Egypt.

During the third quarter of 2006, the Company sold its Performance Coatings & Finishes Business ("Coatings Business"). The results from this segment have been reported as discontinued operations for all the reporting periods. Accordingly, the following discussions generally reflect summary results from continuing operations unless otherwise noted. However, the net income and net income per share discussions include the impact of discontinued operations.

Management's Discussion and Analysis should be read in conjunction with the same discussion included in the Company's 2005 Annual Report, under Part II, Item 7. Reference should also be made to the financial statements included in this Form 10-Q for comparative consolidated balance sheets, statements of income and cash flows.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Management's Discussion and Analysis of Liquidity and Capital Resources and Results of Operations are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make certain estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities during the reporting periods. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from those estimates.

A summary of the Company's significant accounting policies is provided in Note 1 of the Notes to Consolidated Financial Statements, in the Company's 2005 Annual Report. In addition, Management believes the following accounting policies affect the more significant estimates used in preparing the consolidated financial statements.

The consolidated financial statements include the accounts of Ameron International Corporation and all wholly-owned subsidiaries. All material intercompany accounts and transactions have been eliminated. The functional currencies for the Company's foreign operations are the applicable local currencies. The translation from the applicable foreign currencies to U.S. dollars is performed for balance sheet accounts using current exchange rates in effect at the balance sheet date and for revenue and expense accounts using a weighted-average exchange rate during the period. The resulting translation adjustments are recorded in accumulated other comprehensive income. The Company advances funds to certain foreign subsidiaries that are not expected to be repaid in the foreseeable future. Translation adjustments arising from these advances are also included in accumulated other comprehensive income. The timing of repayments of intercompany advances could materially impact the Company's consolidated financial statements. Additionally, earnings of foreign subsidiaries are often permanently reinvested outside the U.S. Unforeseen repatriation of such earnings could result in significant unrecognized U.S. tax liability. Gains or losses resulting from foreign currency transactions are included in other income, net.

Revenue for the Fiberglass-Composite Pipe and Infrastructure Products segments is recognized when risk of ownership and title pass, primarily at the time goods are shipped, provided that an agreement exists between the customer and the Company, the price is fixed or determinable and

collection is reasonably assured. Revenue is recognized for the Water Transmission Group primarily under the percentage-of-completion method, typically based on completed units of production, since products are manufactured under enforceable and binding construction contracts, typically are designed for specific applications, are not interchangeable between projects, and are not manufactured for stock. Revenue for the period is estimated by multiplying total estimated contract revenue by the percentage of completion of the contract and then subtracting the amount of previously recognized revenue. Cost of earned revenue is computed by multiplying estimated contract completion cost by the percentage of completion of the contract and then subtracting the amount of previously recognized cost. In some cases, if products are manufactured for stock or are not related to specific construction contracts, revenue is recognized under the same

criteria used by the other two segments. Revenue under the percentage-of-completion method is subject to a greater level of estimation, which affects the timing of revenue recognition, costs and profits. Estimates are reviewed on a consistent basis and are adjusted periodically to reflect current expectations. Costs attributable to unpriced change orders are treated as costs of contract performance in the period, and contract revenue is recognized if recovery is probable. Disputed or unapproved change orders are treated as claims. Recognition of amounts of additional contract revenue relating to claims occurs when amounts have been received or awarded with recognition based on the percentage-of-completion methodology.

The Company expenses environmental clean-up costs related to existing conditions resulting from past or current operations on a site-by-site basis. Liabilities and costs associated with these matters, as well as other pending litigation and asserted claims arising in the ordinary course of business, require estimates of future costs and judgments based on the knowledge and experience of management and its legal counsel. When the Company's exposures can be reasonably estimated and are probable, liabilities and expenses are recorded. The ultimate resolution of any such exposure to the Company may differ due to subsequent developments.

Inventories are stated at the lower of cost or market with cost determined principally on the first-in, first-out ("FIFO") method. Certain steel inventories used by the Water Transmission Group are valued using the last-in, first-out ("LIFO") method. Significant changes in steel levels or costs could materially impact the Company's financial statements. Reserves are established for excess, obsolete and rework inventories based on age, estimates of salability and forecasted future demand. Management records an allowance for doubtful accounts receivable based on historical experience and expected trends. A significant reduction in demand or a significant worsening of customer credit quality could materially impact the Company's consolidated financial statements.

Investments in unconsolidated joint ventures or affiliates ("joint ventures") over which the Company has significant influence are accounted for under the equity method of accounting, whereby the investment is carried at the cost of acquisition, plus the Company's equity in undistributed earnings or losses since acquisition. Investments in joint ventures over which the Company does not have the ability to exert significant influence over the investees' operating and financing activities are accounted for under the cost method of accounting. The Company's investment in TAMCO, a steel mini-mill in California, is accounted for under the equity method. Investments in Ameron Saudi Arabia, Ltd. and Bondstrand, Ltd. are accounted for under the cost method due to management's current assessment of the Company's influence over these joint ventures.

Property, plant and equipment is stated on the basis of cost and depreciated principally using a straight-line method based on the estimated useful lives of the related assets, generally three to 40 years. The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. If the estimated future, undiscounted cash flows from the use of an asset are less than its carrying value, a write-down is recorded to reduce the related assets to estimated fair value. The Company also reviews intangible assets for impairment at least annually, based on the estimated future, discounted cash flows associated with such assets. Actual cash flows may differ significantly from estimated cash flows. Additionally, current estimates of future cash flows may differ from subsequent estimates of future cash flows. Changes in estimated or actual cash flows could materially impact the Company's consolidated financial statements.

The Company is self-insured for a portion of the losses and liabilities primarily associated with workers' compensation claims and general, product and vehicle liability. Losses are accrued based upon the Company's estimates of the aggregate liability for claims incurred using historical experience and certain actuarial assumptions followed in the insurance industry. The estimate of self-insurance liability includes an estimate of incurred but not reported claims, based on data compiled from historical experience. Actual experience could differ significantly from these estimates and could materially impact the Company's consolidated financial statements. The Company purchases varying levels of insurance to cover losses in excess of the self-insured limits. Currently, the Company's self-insurance limits are $1.0 million per workers' compensation claim, $.1 million per general, property or product liability claim, and $.25 million per vehicle liability claim.

The Company follows the guidance of Statement of Financial Accounting Standards ("SFAS") No. 87, *Employers' Accounting for Pensions*, and SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, when accounting for pension and other postretirement benefits. Under these accounting standards, assumptions are made regarding the valuation of benefit obligations and the performance of plan assets that are controlled and invested by third-party fiduciaries. Delayed recognition of differences between actual results and expected or estimated results is a guiding principle of these standards. Such delayed recognition provides a gradual recognition of benefit obligations and

investment performance over the working lives of the employees who benefit under the plans, based on various assumptions. Assumed discount rates are used to calculate the present values of benefit payments which are projected to be made in the future, including projections of increases in employees' annual compensation and health care costs. Management also projects the future return on invested assets based principally on prior performance. These projected returns reduce the net benefit costs the Company records in the current period. Actual results could vary significantly from projected results, and such deviation could materially impact the Company's consolidated financial statements. Management consults with its actuaries when determining these assumptions. Unforecasted program changes, including termination, freezing of benefits or acceleration of benefits, could result in an immediate recognition of unrecognized benefit obligations and such recognition could materially impact the Company's consolidated financial statements.

Management incentive compensation is accrued based on current estimates of the Company's ability to achieve short-term and long-term performance targets.

Deferred income tax assets and liabilities are computed for differences between the financial statement and income tax bases of assets and liabilities. Such deferred income tax asset and liability computations are based on enacted tax laws and rates applicable to periods in which the differences are expected to reverse. Valuation allowances are established, when necessary, to reduce deferred income tax assets to the amounts expected to be realized. Quarterly income taxes are estimated based on the mix of income by jurisdiction forecasted for the full fiscal year. The Company believes that it has adequately provided for tax-related matters. The Company is subject to examination by taxing authorities in various jurisdictions. Matters raised upon audit may involve substantial amounts, and an adverse finding could have a material impact on the Company's consolidated financial statements.

LIQUIDITY AND CAPITAL RESOURCES

The following discussion generally combines the impact of both continuing and discontinued operations unless otherwise noted.

As of September 3, 2006, the Company's working capital totaled $283.3 million, an increase of $67.2 million, from working capital of $216.1 million as of November 30, 2005. The increase was caused by higher business activity and the sale of the Coatings Business for cash. Cash and cash equivalents totaled $141.0 million as of September 3, 2006, compared to $44.7 million as of November 30, 2005.

In accordance with SFAS No. 95, *Statement of Cash Flows*, the consolidated statements of cash flows include cash flows for both continuing and discontinued operations. For the nine months ended September 3, 2006, net cash of $2.4 million was generated from operating activities of continuing and discontinued operations, compared to $8.0 million used in the nine months ended August 28, 2005. In 2006, $10.1 million was used by discontinued operations. The higher operating cash flow in 2006 was primarily due to higher earnings. In the nine months ended August 28, 2005, the Company's cash from operating activities included net income, less gain on sale of assets, of $1.4 million, plus non-cash adjustments (depreciation, amortization, deferred taxes, dividends from joint-ventures in excess of equity income and stock compensation expense) of $15.8 million, offset by changes in operating assets and liabilities of $41.7 million. Cash was used for operating assets due to the seasonal level of business activity in the first nine months of 2005. In the nine months ended September 3, 2006, the Company's cash provided by operating activities included net income, less gains on sales of assets and discontinued operations of $9.3 million, plus similar non-cash adjustments of $13.5 million, offset by corresponding changes in operating assets and liabilities of $42.1 million.

Net cash generated from investing activities totaled $97.5 million during the nine months ended September 3, 2006, compared to $15.0 million used in the nine months ended August 28, 2005. In 2006, the Company generated net proceeds of $9.0 million from the sale of real property in Brea, California. The proceeds were transferred directly to a trust established for tax-free exchange under Internal Revenue Code Section 1031 and treated as restricted cash. In addition, the Company generated $115.0 million from the sale of the Coatings Business. Net cash used in investing activities consisted of capital expenditures of $18.1 million, compared to $17.4 million in the same period of 2005. Capital expenditures were primarily for normal replacement and upgrades of machinery and equipment in both 2005 and 2006 and for a new fiberglass pipe plant in Malaysia in 2005. Additionally, the assets of a steel fabrication operation were acquired in 2006 for approximately $1.0 million. During the year ending November 30, 2006, the Company anticipates spending between $25 and $30 million on capital expenditures. Capital expenditures are expected to be funded by existing cash balances, cash generated from operations or additional borrowings.

Net cash used in financing activities totaled $4.5 million during the nine months ended September 3, 2006, compared to $13.6 million provided in the nine months ended August 28, 2005. Net cash used in 2006 consisted of net payment of debt of $2.2 million, payment of common stock dividends of $5.3 million and treasury stock purchases of $1.2 million related to the vesting of restricted shares. The net cash provided by financing activities in 2006 consisted of the issuance of common stock related to exercised stock options of $4.2 million. Net cash provided by financing activities in 2005 included net borrowings of $17.4 million and a similar issuance of common stock of $1.8 million, offset by dividends of $5.1 million and stock purchases of $.5 million. Net borrowings were higher in 2005 because of a greater use of the Company's

bank lines.

The Company utilizes a $100.0 million revolving credit facility with six banks (the "Revolver"). Under the Revolver, the Company may, at its option, borrow at floating interest rates based on specified margins over money market rates, at any time until September 2010, when all borrowings under the Revolver must be repaid.

The Company's lending agreements contain various restrictive covenants, including the requirement to maintain specified amounts of net worth and restrictions on cash dividends, borrowings, liens, investments, guarantees, and financial covenants. The Company is required to maintain consolidated net worth of $181.4 million plus 50% of net income and 75% of proceeds from any equity issued after January 24, 2003. The Company's consolidated net worth exceeded the covenant amount by $108.2 million as of September 3, 2006. The Company is required to maintain a consolidated leverage ratio of consolidated funded indebtedness to earnings before interest, taxes, depreciation and amortization ("EBITDA") of no more than 2.5 times. As of September 3, 2006, the Company maintained a consolidated leverage ratio

of 1.12 times EBITDA. Lending agreements require that the Company maintain qualified consolidated tangible assets at least equal to the outstanding secured funded indebtedness. As of September 3, 2006, qualifying tangible assets equaled 1.95 times funded indebtedness. Under the most restrictive fixed charge coverage ratio, the sum of EBITDA and rental expense less cash taxes must be at least 1.25 times the sum of interest expense, rental expense, dividends and scheduled funded debt payments. As of September 3, 2006, the Company maintained such a fixed charge coverage ratio of 2.23 times.

Cash and cash equivalents at September 3, 2006 totaled $141.0 million, an increase of $96.3 million from November 30, 2005. At September 3, 2006, the Company had total debt outstanding of $95.8 million, compared to $95.4 million at November 30, 2005, and approximately $113.9 million in unused committed and uncommitted credit lines available from foreign and domestic banks. The Company's highest borrowing and the average borrowing levels during 2006 were $105.8 million and $100.8 million, respectively.

Management believes that cash flow from operations and current cash balances, together with currently available lines of credit, will be sufficient to meet operating requirements in 2006. The Company contributed $21.6 million to the U.S. pension plan in the first nine months of 2006. The Company contributed $.9 million to the non-U.S. pension plan for the first nine months of 2006 and expects to contribute $.3 million in the remaining period of 2006. The amount of contribution to the U.S. pension plan reflects application of an Additional Funding Charge ("AFC") requirement. Pension contributions are expected to decline to approximately $5.0 million for the next two years. Cash available from operations could be affected by any general economic downturn or any decline or adverse changes in the Company's business, such as a loss of customers or significant raw material price increases. Management does not believe it likely that business or economic conditions will worsen or that costs will increase sufficiently to impact short-term liquidity.

The Company's contractual obligations and commercial commitments at September 3, 2006 are summarized as follows (in thousands):

Contractual Obligations

	Payments Due by Period				
	Total	Less than 1 Year	1-3 Years	3-5 Years	After 5 Years
Long-Term Debt (a)	$ 95,807	$ 10,000	$ 26,488	$ 30,645	$ 28,674
Interest Payments on Debt (b)	10,484	1,760	4,898	3,000	826
Operating Leases	33,408	3,658	7,148	5,500	17,102
Purchase Obligation (c)	10,759	10,759	-	-	-
Total Contractual Obligations (d)	$ 150,458	$ 26,177	$ 38,534	$ 39,145	$ 46,602

Commercial Obligations

	Commitments Expiring Per Period				
	Total	Less than 1 Year	1-3 Years	3-5 Years	After 5 Years
Standby Letters of Credit (e)	$ 2,016	$ 1,946	$ 70	$ -	$ -
Total Commercial Commitments (d)	$ 2,016	$ 1,946	$ 70	$ -	$ -

(a) Included in long-term debt is $6,902 outstanding under a revolving credit facility, which is supported by the Revolver.

(b) Future interest payments related to debt obligations, excluding the Revolver and the industrial development bonds.

(c) Obligation to purchase sand used in the Company's ready-mix operations in Hawaii.

(d) The Company has no capitalized lease obligations, guarantees, or standby repurchases obligations.

(e) Not included are standby letters of credit totaling $16,067 supporting industrial development bonds with principal of $15,700. The principal amount of the industrial development bonds is included in long-term debt. The standby letters of credit are issued under the Revolver.

AMERON INTERNATIONAL CORPORATION AND SUBSIDIARIES

RESULTS OF OPERATIONS

General

Income from continuing operations totaled $17.0 million, or $1.91 per diluted share, on sales of $139.9 million for the quarter ended September 3, 2006, compared to income from continuing operations of $11.6 million, or $1.35 per diluted share, on sales of $136.6 million for the same period in 2005. All reportable segments other than the Water Transmission Group had higher sales and profits due to improved market and business conditions. Income from continuing operations was higher in 2006 due to lower interest and income tax expenses. Equity in earnings of TAMCO, Ameron's 50%-owned steel venture in California, increased by $1.8 million, compared to the third quarter of 2005.

Income from continuing operations totaled $37.9 million, or $4.29 per diluted share, on sales of $398.6 million for the nine months ended September 3, 2006, compared to income from continuing operations of $18.5 million, or $2.16 per diluted share, on sales of $355.6 million for the same period in 2005. All segments had significantly higher sales and profits, except the Water Transmission Group. Income from continuing operations was higher due primarily to sales growth, the gain from the sale of the Brea property and the higher legal costs and expenses of $7.6 million in 2005. Equity in earnings of TAMCO increased by $3.3 million, compared to the same period in 2005.

Income from discontinued operations, net of taxes, totaled $1.0 million, or $.11 per diluted share for the quarter ended September 3, 2006, compared to $1.9 million, or $.23 per diluted share, for the same period in 2005. Income from discontinued operations, net of taxes, totaled $2.4 million, or $.27 per diluted share, for the nine months ended September 3, 2006, compared to $.8 million, or $.10 per diluted share, for the same period in 2005. During the third quarter of 2006, the Company completed the sale of its Coatings Business and recognized a pretax gain of $1.1 million. Discontinued operations generated sales of $41.8 million and $56.5 million for the third quarter of 2006 and 2005, respectively. Discontinued operations generated sales of $152.2 million and $152.5 million for the first nine months of 2006 and 2005, respectively.

Sales

Sales increased $3.4 million in the third quarter of 2006, compared to the similar period in 2005. Year-to-date sales increased $43.0 million in 2006, compared to the first nine months of 2005. All segments, except the Water Transmission Group, had higher sales in the third quarter and nine months ended September 3, 2006 due to improved demand, project timing and price increases.

Fiberglass-Composite Pipe's sales increased $11.1 million, or 29.6%, in the third quarter, and $35.2 million, or 36.6%, in the first nine months of 2006, compared to the similar periods of 2005. Sales from operations in the U.S. increased $6.5 million and $19.2 million for the third quarter and first nine months of 2006 primarily due to increased demand for onshore oilfield piping. Sales from Asian operations increased $3.9 million and $10.2 million for the third quarter and first nine months of 2006, driven most recently by increasing activity in the industrial and offshore segments. Sales in Europe increased $.7 million and $5.7 million for the third quarter and first nine months of 2006 due to volume growth in industrial and marine markets. The strong demand for oilfield and marine piping continues to be driven by high oil prices and the high cost of steel piping, the principal substitute for fiberglass pipe. The outlook for the Fiberglass Composite Pipe Group remains favorable.

The Water Transmission Group's sales decreased $18.7 million, or 33.6%, in the third quarter, and $18.7 million, or 13.7% in the first nine months of 2006, compared to the similar periods in 2005. The Water Transmission Group benefited from a major sewer pipe project in Northern California throughout 2005, which was completed in the first quarter of 2006. Revenue is recognized in the Water Transmission Group primarily under the percentage-of-completion method and is subject to a certain level of estimation, which affects the timing of revenue recognition, costs and profits. Estimates are reviewed on a consistent basis and are adjusted when actual results are expected to significantly differ from those estimates. The Water Transmission Group entered 2006 with a lower backlog due to completion of most of the major sewer project in Northern California in 2005. Market conditions remain soft due to fiscal constraints and continuation of a short-term cyclical slowdown in water infrastructure projects in the Company's markets.

Infrastructure Products' sales increased $11.0 million, or 25.1%, in the third quarter, and $26.9 million, or 21.9%, in the first nine months of 2006, compared to the similar periods in 2005. Higher demand for concrete and steel poles was due principally to the continued strong housing market and improved market penetration, particularly in the southeast U.S. Ameron's Hawaiian operation had higher sales due to the continued strength of the governmental, commercial and residential construction markets on Oahu and Maui. The forecast for the Infrastructure Products Group remains favorable.

AMERON INTERNATIONAL CORPORATION AND SUBSIDIARIES

Gross Profit

Gross profit in the third quarter of 2006 was $36.1 million, or 25.8% of sales, compared to $37.5 million, or 27.5% of sales, in the third quarter of 2005. Year-to-date gross profit in 2006 was $99.4 million, or 24.9% of sales, compared to $91.0 million, or 25.6% of sales for the same period of 2005. Gross profit decreased $1.5 million and increased $8.5 million, respectively, in the third quarter and first nine months of 2006, compared to the similar periods in 2005. Margins decreased due to continued sluggish market conditions within the Water Transmission Group offset by the improved product mix for both the Fiberglass-Composite Pipe and Infrastructure Products Groups.

Fiberglass-Composite Pipe Group's gross profit increased $5.6 million in the third quarter and $13.3 million for the first nine month of 2006, compared to the same periods of 2005. Profit margins were 34.1% in the quarter and 32.9% for the first nine months, compared to 29.2% for the quarter and 31.2% for the first nine months of 2005. Margins were higher in the third quarter due to improvements in product and market mix, and price increases. Increased sales volume generated additional gross profit of $3.2 million for the quarter and $11.0 million for the first nine months in 2006. The unfavorable mix earlier in 2006 was primarily due to volume growth in the international industrial markets and higher sales in the onshore oilfield market. The situation improved due to price increases implemented throughout 2006.

Water Transmission Group's gross profit decreased $10.9 million in the third quarter and $16.6 million for the first nine months of 2006, compared to the same periods of 2005. Profit margins declined to 13.9% in the quarter and 25.5% for the first nine months compared to 28.7% for the quarter and 25.5% for the first nine months of 2005. Lower sales volume reduced profit by $2.1 million for the quarter, while lower margins reduced gross profit by $5.4 million for the quarter and $4.8 million for the first nine months of 2006. Margins were unfavorably impacted by the mix of contract margins, start-up costs associated with the introduction of wind towers and lower efficiencies due to lower sales.

Gross profit in the Infrastructure Products Group increased $3.6 million in the third quarter and $9.9 million for the first nine months of 2006, compared to the same periods of 2005. Profit margins improved to 24.6% in the quarter and 23.8% for the first nine months compared to 22.6% for the quarter and 21.0% for the first nine months of 2005. Increased sales volume generated additional gross profit of $2.5 million for the quarter and $5.6 million for the first nine months in 2006, while higher margins generated additional gross profit of $1.1 million for the quarter and $4.2 million for the first nine months in 2006. Higher margins were driven by price increases and operating efficiencies due to increased production levels.

Selling, General and Administrative Expenses

Selling, general and administrative ("SG&A") expenses totaled $22.3 million, or 15.9% of sales, in the third quarter of 2006, compared to $22.6 million, or 16.6% of sales, in the third quarter of 2005. The $.3 million decrease included higher incentive and stock compensation expenses of $1.5 million offset by lower self-insurance and other expenses of $1.8 million.

For the nine months ended September 3, 2006, SG&A expenses totaled $68.8 million, or 17.3% of sales, compared to $68.6 million, or 19.3% of sales in the same period in 2005. The $.2 million increase included higher incentive and stock compensation expenses of $6.1 million and higher commission and administrative expenses of $4.4 million associated with higher sales offset by lower legal fees and settlement costs of $7.6 million and $2.7 million self-insurance expenses incurred in 2005.

Other Income

Other income increased from $.2 million in the third quarter of 2005 to $1.5 million in the third quarter of 2006 due primarily to foreign exchange gains. Other income increased from $.9 million in the first nine months of 2005 to $10.8 million in the first nine months of 2006 due to the $9.0 million gain from the sale of the Brea property. Other income included royalties and fees from licensees, foreign currency transaction losses, and other miscellaneous income. .

Interest

Net interest expense totaled $.6 million in the third quarter of 2006, compared to $1.6 million in the third quarter of 2005. Net interest expense was $2.5 million in the first nine months of 2006, compared to $4.2 million in the first nine months of 2005. The decrease in net interest expense was due to higher interest income from short-term investments and the higher cash balances in the third quarter of 2006 because of the sale of the Coatings Business.

AMERON INTERNATIONAL CORPORATION AND SUBSIDIARIES

Provision for Income Taxes

Income taxes decreased to $2.5 million in the third quarter of 2006 from $5.1 million in the third quarter of 2005. Income taxes increased to $10.5 million in the first nine months of 2006, compared to $6.9 million in the comparable period of 2005. The effective tax rate decreased to 26.9% in first nine months of 2006 from 36.0% for the same period of 2005. The effective tax in 2006 was lower due to tax benefits of $1.1 million and $2.5 million, respectively, recorded in the second and third quarters of 2006 primarily as a result of settlements of the 1996 - 1998 and 1999 - 2002 IRS examinations and approval of the Company's research and development credit refund claims by the Congressional Joint Committee on Taxation. The effective tax rate for the first nine months of 2006 is also based on forecasted full-year earnings and the anticipated mix of domestic and foreign earnings. Income from certain foreign operations and joint ventures is taxed at rates that are lower than the U.S. statutory tax rates. The effective tax rate for the nine months of 2006 is not necessarily indicative of the tax rate for the full fiscal year.

Equity in Earnings of Joint Venture, Net of Taxes

Equity in earnings of joint venture increased to $4.9 million in the third quarter of 2006, compared to $3.1 million in 2005. Equity income increased to $9.5 million in the first nine months of 2006, compared to $6.2 million in the same period of 2005. Equity income increased due to TAMCO, Ameron's 50%-owned mini-mill in California. TAMCO's profits in the third quarter and first nine months rose due to increased demand for steel rebar and higher selling prices. The outlook for TAMCO remains positive.

Income from Discontinued Operations, Net of Taxes

During the third quarter of 2006, the Company completed the sale of the Coatings Business and recognized a pretax gain of $1.1 million. Provision for income taxes related to the gain was $.9 million, which resulted in a net gain of $.2 million for the third quarter and nine months of 2006. Income from discontinued operations before disposal, net of taxes, totaled $.8 million for the quarter ended September 3, 2006, compared to $1.9 million for the same period in 2005. Income from discontinued operations, net of taxes, totaled $2.1 million for the nine months ended September 3, 2006, compared to $.8 million for the same period in 2005.

Item 3. Quantitative and Qualitative Market Risk Disclosure

No material changes have occurred in the quantitative and qualitative market risk disclosure of the Company as presented in Ameron's 2005 Annual Report.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedure - Management has established disclosure controls and procedures to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms and that such information relating to the Company, including its consolidated subsidiaries, is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures

Based on their evaluation as of September 3, 2006, the principal executive officer and principal financial officer of the Company have concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) are effective to ensure that the information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

There has been no change in the Company's internal control over financial reporting that occurred during the last fiscal quarter covered by this report that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

CAUTIONARY STATEMENT FOR PURPOSES OF THE "SAFE HARBOR" PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

Any of the above statements that refer to the Company's forecasted, estimated or anticipated future results are forward-looking and reflect the Company's current analysis of existing trends and information. Actual results may differ from current expectations based on a number of factors

affecting Ameron's businesses, including competitive conditions and changing market conditions. Matters affecting the economy generally, including the state of economies worldwide, can affect the Company's results. These forward-looking statements represent the Company's judgment only as of the date of this report. Since actual results could differ materially, the reader is cautioned not to rely on these forward-looking statements. Moreover, the Company disclaims any intent or obligation to update these forward looking statements.

AMERON INTERNATIONAL CORPORATION AND SUBSIDIARIES

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Company is one of numerous defendants in various asbestos-related personal injury lawsuits. These cases generally seek unspecified damages for asbestos-related diseases based on alleged exposure to products previously manufactured by the Company and others, and at this time the Company is generally not aware of the extent of injuries allegedly suffered by the individuals or the facts supporting the claim that injuries were caused by the Company's products. Based upon the information available to it at this time, the Company is not in a position to evaluate its potential exposure, if any, as a result of such claims or future similar claims, if any, that may be filed. Hence, no amounts have been accrued for loss contingencies related to these lawsuits in accordance with SFAS No. 5, *Accounting for Contingencies*. The Company continues to vigorously defend all such lawsuits. As of September 3, 2006, the Company was a defendant in asbestos-related cases involving 149 claimants, compared to 924 claimants as of June 4, 2006. The Company is not in a position to estimate the number of additional claims that may be filed against it in the future. For the quarter ended September 3, 2006, there were six new claimants, dismissals and/or settlements involving 781 claimants, and no judgments. Net costs and expenses incurred by the Company during the quarter ended September 3, 2006 in connection with asbestos-related claims were less than $.1 million.

The Company is one of numerous defendants in various silica-related personal injury lawsuits. These cases generally seek unspecified damages for silica-related diseases based on alleged exposure to products previously manufactured by the Company and others, and at this time the Company is not aware of the extent of injuries allegedly suffered by the individuals or the facts supporting the claim that injuries were caused by the Company's products. Based upon the information available to it at this time, the Company is not in a position to evaluate its potential exposure, if any, as a result of such claims or future similar claims, if any, that may be filed. Hence, no amounts have been accrued for loss contingencies related to these lawsuits in accordance with SFAS No. 5. The Company continues to vigorously defend all such lawsuits. As of September 3, 2006, the Company was a defendant in silica-related cases involving 129 claimants, compared to 241 claimants as of June 4, 2006. The Company is not in a position to estimate the number of additional claims that may be filed against it in the future. For the quarter ended September 3, 2006, there were no new claimants, dismissals and/or settlements involving 112 claimants, and no judgments. Net costs and expenses incurred by the Company during the quarter ended September 3, 2006 in connection with silica-related claims were less than $.2 million.

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

Terms of lending agreements place restrictions on cash dividends, stock repurchases, borrowings, investments and guarantees. Under the most restrictive provisions of these agreements, approximately $27.5 million of consolidated retained earnings were not restricted at September 3, 2006.

ISSUER PURCHASES OF EQUITY SECURITIES

Period	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid per Share (or Unit)	(c) Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased under the Plans or Programs*
6/5/06 to 7/2/06	-	N/A	-	40,924
7/3/06 to 8/6/06	-	N/A	-	40,924
8/7/06 to 9/3/06	-	N/A	-	40,924

* Shares may be repurchased by the Company to pay taxes applicable to the vesting of restricted stock. The number of shares does not include shares which may be repurchased to pay social security taxes applicable to the vesting of such restricted stock.

AMERON INTERNATIONAL CORPORATION AND SUBSIDIARIES

Item 6. Exhibits and Reports on Form 8-K

(a) EXHIBITS:

EXHIBIT	EXHIBITS OF AMERON
31.1	Section 302 Certification of Chief Executive Officer
31.2	Section 302 Certification of Chief Financial Officer
32	Section 906 Certification of Chief Executive Officer and Chief Financial Officer *

(b) REPORTS ON FORM 8-K

Five reports on Form 8-K were filed by the Company during the third quarter of 2006 as follows:

June 22, 2006 reporting the Company's results of operations for the second quarter ended June 4, 2006, as reported in a press release dated June 22, 2006.

June 23, 2006 reporting the Company's quarterly dividend of $.20 per share, as reported in a press release dated June 23, 2006.

June 23, 2006 reporting the Company's amendment to its By-Laws to increase the number of directors on its Board of Directors, and the appointment of William D. Horsfall as a new Director and member of the Audit Committee of the Board of Directors.

June 30, 2006 reporting the Company's entry into an asset purchase agreement to sell the Performance Coatings & Finishes business, as reported in a press release dated June 29, 2006.

August 7, 2006 reporting the Company's completion of the sale of the Performance Coatings & Finishes business, effective August 1, 2006, as reported in a press release dated August 2, 2006, and the associated Pro Forma financial information. On August 16, 2006 a Form 8-K/A was filed to amend and supplement the previous filing.

* A signed original of this written statement required by Section 906 has been provided to Ameron International Corporation and will be retained by Ameron International Corporation and furnished to the Securities and Exchange Commission or its staff upon request.

SIGNATURE PAGE

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.

AMERON INTERNATIONAL CORPORATION

By: /s/ James R. McLaughlin

James R. McLaughlin, Senior Vice President, Chief Financial Officer & Treasurer

Date: October 4, 2006

Times New Roman" SIZE="2">Other lease revenues 5,345 11,066 24,346

Total revenues

$24,584 $24,790 $36,256

In 2011, royalty revenue increased principally as a result of higher oil prices and increased oil production which was partially offset by decreases in natural gas production and lower prices in our owned and consolidated

Table of Contents

properties. Increased oil prices contributed about $3,608,000 and oil production increases contributed about $2,666,000, which was offset by decreased natural gas prices resulting in a reduction of about $350,000 and decreased natural gas production resulting in a reduction of about $411,000.

In 2011, other lease revenues include $2,250,000 in lease bonus payments as a result of leasing about 8,100 net mineral acres for an average of about $280 per acre, $1,555,000 related to a mineral seismic exploration agreement associated with 31,100 acres in Louisiana and $992,000 related to delay rental payments.

In 2010, royalty revenues increased as a result of higher oil prices and oil production partially offset by decreases in natural gas production in our owned and consolidated properties. Increased oil prices contributed about $1,873,000 and oil production increases contributed about $466,000. The production increase primarily relates to new oil wells commencing production in late 2009 and early 2010. Increased natural gas prices contributed about $245,000 which was offset by decreased natural gas production of about $774,000.

In 2010, other lease revenues include $7,655,000 in lease bonus payments as a result of leasing about 16,900 net mineral acres for an average of about $460 per acre and $2,168,000 related to delay rental payments. In addition, other lease revenues include about $1,126,000 as a result of an option exercised to extend an existing lease on over 3,200 acres.

In 2009, royalty revenues declined principally due to lower natural gas and oil prices, which were partially offset by higher production volume principally due to the increased number of new wells commencing production.

In 2009, other lease revenues include $21,333,000 in lease bonus payments as a result of leasing over 25,800 net mineral acres for an average of about $830 per acre and $2,530,000 from delay rental payments. This leasing activity was located principally in Trinity County, Texas.

Oil and natural gas produced and average unit prices related to our royalty and non-operating working interests follows:

	For the Year		
	2011	**2010**	**2009**
Consolidated entities:			
Oil production (barrels)	151,900	115,400	107,200
Average price per barrel	$ 96.84	$ 73.09	$ 56.85
Natural gas production (millions of cubic feet)	1,128.6	1,223.6	1,411.6
Average price per thousand cubic feet	$ 4.01	$ 4.32	$ 4.12
Our share of ventures accounted for using the equity method:			
Natural gas production (millions of cubic feet)	493.4	572.8	82.1
Average price per thousand cubic feet	$ 3.81	$ 4.12	$ 3.80
Total consolidated and our share of equity method ventures:			
Oil production (barrels)	151,900	115,400	107,200
Average price per barrel	$ 96.84	$ 73.09	$ 56.85
Natural gas production (millions of cubic feet)	1,622.0	1,796.4	1,493.7
Average price per thousand cubic feet	$ 3.95	$ 4.26	$ 4.10

At year-end 2011, there were 530 productive wells operated by others on our leased mineral acres compared to 494 at year-end 2010 and 472 at year-end 2009.

Our share of ventures natural gas production increased in 2010 as a result of 16 wells that began producing from the Barnett Shale natural gas formation.

Operating expenses consist of:

	For the Year		
	2011	2010	2009
	(In thousands)		
Professional and consulting services	$ 2,906	$ 566	$ 872
Employee compensation and benefits	2,407	1,182	1,299
Depreciation	318	269	184
Property taxes	257	255	301
Other	1,149	710	698
Total operating expenses	$ 7,037	$ 2,982	$ 3,354

In 2011, professional and consulting services increased primarily due to non-cash amortization of contingent consideration paid to the seller of a water resources company acquired in fourth quarter 2010. These costs are being amortized ratably over the performance period assuming certain milestones are achieved by July 2014. Employee compensation and benefits increased as a result of incremental staffing to support our oil, natural gas and water interests.

A summary of our mineral acres [(a)] at year-end 2011 follows:

State	Unleased	Leased[(b)]	Held By Production[(c)]	Total[(d)]
Texas	196,000	29,000	27,000	252,000
Louisiana	120,000	19,000	5,000	144,000
Georgia	157,000			157,000
Alabama	40,000			40,000
California	1,000			1,000
Indiana	1,000			1,000
	515,000	48,000	32,000	595,000

(a) Includes ventures.

(b) Includes leases in primary lease term or for which a delayed rental payment has been received. In the ordinary course of business, leases covering a significant portion of leased net mineral acres may expire from time to time in a single reporting period.

(c) Acres being held by production are producing oil or natural gas in paying quantities.

(d) Texas, Louisiana, California and Indiana net acres are calculated as the gross number of surface acres multiplied by our percentage ownership of the mineral interest. Alabama and Georgia net acres are calculated as the gross number of surface acres multiplied by our estimated percentage ownership of the mineral interest based on county sampling. Excludes 477 net mineral acres located in Colorado including 379 acres leased and 29 acres held by production.

In addition, we have water interests in about 1,550,000 acres, including a 45 percent nonparticipating royalty interest in groundwater produced or withdrawn for commercial purposes or sold from approximately 1,400,000 acres in Texas, Louisiana, Georgia and Alabama and about 17,800 acres of groundwater leases in central Texas. We have not received significant revenue or earnings from these interests.

Fiber Resources

Our fiber resources segment focuses principally on the management of our timber holdings and recreational leases. We have about 131,000 acres of timber we own directly or through ventures, primarily in Georgia, and about 17,000 acres of timber under lease. Our fiber resources segment revenues are principally derived from the

46

Table of Contents

sales of wood fiber from our land and leases for recreational uses. We have sold over 217,000 acres of timberland since year-end 2008 as a result of our strategic initiatives and through our retail land sales program. As a result of the reduced acreage from executing these land sales, future segment revenues and earnings are anticipated to be lower.

A summary of our fiber resources results follows:

	For the Year		
	2011	2010	2009
	(In thousands)		
Revenues	$ 4,821	$ 8,301	$ 15,559
Cost of sales	(1,072)	(1,640)	(3,396)
Operating expenses	(2,060)	(2,274)	(2,728)
	1,689	4,387	9,435
Other operating income	181	671	187
Equity in earnings (loss) of unconsolidated ventures	23		
Segment earnings	$ 1,893	$ 5,058	$ 9,622

Other operating income principally represents gains from partial termination of a timber leases.

Revenues consist of:

	For the Year		
	2011	2010	2009
	(In thousands)		
Fiber	$ 3,229	$ 6,491	$ 13,478
Recreational leases and other	1,592	1,810	2,081
Total revenues	$ 4,821	$ 8,301	$ 15,559

Fiber sold consists of:

	For the Year		
	2011	2010	2009
Pulpwood tons sold	266,200	392,900	810,100
Average pulpwood price per ton	$ 8.69	$ 9.93	$ 8.53
Sawtimber tons sold	56,800	144,300	331,300
Average sawtimber price per ton	$ 16.13	$ 17.94	$ 19.82
Total tons sold	323,000	537,200	1,141,400
Average price per ton	$ 10.00	$ 12.08	$ 11.81

In 2011 and 2010, total fiber tons sold decreased principally due to selling over 217,000 acres of timberland since year-end 2008 as a result of our strategic initiatives and through our retail land sales program. In 2010 and 2009, total price per ton was higher due to a higher proportional mix of sawtimber versus pulpwood.

The majority of our fiber sales were to Temple-Inland, recently acquired by International Paper, at market prices.

Information about our recreational leases follows:

	For the Year		
	2011	**2010**	**2009**
Average recreational acres leased	174,500	208,100	249,200
Average price per leased acre	$ 8.80	$ 8.32	$ 8.25

Table of Contents

Operating expenses consist of:

	For the Year		
	2011	2010	2009
	(In thousands)		
Employee compensation and benefits	$ 945	$ 1,115	$ 1,241
Facility and long-term timber lease costs	445	424	544
Professional services	374	342	471
Other	296	393	472
Total operating expenses	$ 2,060	$ 2,274	$ 2,728

Items Not Allocated to Segments

Unallocated items represent income and expenses managed on a company-wide basis and include general and administrative expenses, share-based compensation, gain on sale of assets, interest expense and other non-operating income and expense. General and administrative expenses principally consist of accounting and finance, tax, legal, human resources, internal audit, information technology and our board of directors. These functions support all of our business segments and are not allocated.

General and administrative expenses consist of:

	For the Year		
	2011	2010	2009
	(In thousands)		
Professional services	$ 6,578	$ 2,937	$ 5,871
Employee compensation and benefits	5,662	5,480	5,687
Depreciation and amortization	1,393	1,480	1,728
Insurance costs	1,083	1,235	1,308
Facility costs	800	1,214	1,143
Other	4,594	4,995	6,662
Total general and administrative expenses	$ 20,110	$ 17,341	$ 22,399

In 2011, professional services include $3,187,000 associated with proposed private debt offerings that we withdrew as a result of deterioration in terms available to us in the capital markets. In 2009, professional services included about $3,200,000 paid to outside advisors regarding an evaluation by our Board of Directors of an unsolicited shareholder proposal. In 2009, other expenses include $2,213,000 in non-cash impairment charges related to the sale of our undivided 15 percent interest in corporate aircraft contributed to us by Temple-Inland at spin-off.

Our share-based compensation expense fluctuates because a portion of our awards are cash settled and as a result are affected by changes in the market price of our common stock. In 2011, share-based compensation decreased principally as a result of a decline in our stock price and its impact on cash-settled awards.

Gain on sale of assets represents gains associated with our 2009 strategic initiatives, which we completed in 2011. In 2011, we recognized gains of $61,784,000 from the sale of 57,000 acres of timberland in Georgia, Alabama and Texas, in 2010, we recognized gains of $28,607,000 from the sale of 24,000 acres of timberland in Georgia, Alabama and Texas and in 2009, we recognized gains of $104,047,000 from the sale of 95,000 acres of timberland in Georgia and Alabama.

In 2010, interest expense decreased principally due to lower interest rates as a result of the maturity of our interest rate swap agreement, lower average debt levels outstanding and decreased amortization of prepaid loan fees due to refinancing and extending our senior credit facility.

48

Income Taxes

Our effective tax rate and the benefit attributable to noncontrolling interests was 25 percent and 6 percent in 2011, 30 percent and 3 percent in 2010, and 37 percent and 1 percent in 2009. Our 2011 and 2010 rates include benefits for percentage depletion and charitable contributions related to timberland conservation while our 2009 rate includes a benefit from percentage depletion and a federal income tax rate change for qualified timber gains pursuant to the Food, Conservation and Energy Act of 2008.

We have not provided a valuation allowance for our deferred tax asset because we believe it is likely it will be recoverable in future periods based on considerations including taxable income in prior carryback years, future reversals of existing temporary differences, tax planning strategies and future taxable income. If these sources of income are not sufficient in future periods, we may be required to provide a valuation allowance for our deferred tax asset.

Capital Resources and Liquidity

Sources and Uses of Cash

We operate in cyclical industries and our cash flows fluctuate accordingly. Our principal operating cash requirements are for the acquisition and development of real estate, either directly or indirectly through ventures, taxes, interest and compensation. Our principal sources of cash are proceeds from the sale of real estate and timber, the cash flow from minerals and income producing properties, borrowings, and reimbursements from utility and improvement districts. Operating cash flows are affected by the timing of the payment of real estate development expenditures and the collection of proceeds from the eventual sale of the real estate, the timing of which can vary substantially depending on many factors including the size of the project, state and local permitting requirements and availability of utilities, and by the timing of oil and natural gas leasing and production activities. Working capital is subject to operating needs, the timing of sales of real estate and timber, the timing of collection of mineral royalties or mineral lease payments, collection of receivables, reimbursement from utility and improvement districts and the payment of payables and expenses.

Cash Flows from Operating Activities

Cash flows from our real estate development activities, undeveloped land sales, income producing properties, timber sales, mineral and recreational leases and reimbursements from utility and improvement districts are classified as operating cash flows.

Net cash provided by (used for) operations was $34,992,000 in 2011, $13,551,000 in 2010 and $142,120,000 in 2009.

In 2011, the sale of 57,000 acres of timberland in accordance with our 2009 strategic initiatives generated net proceeds of $86,018,000. Expenditures for development and acquisitions exceeded non-cash real estate cost of sales principally due to our acquisition of a non-performing loan secured by a lien on approximately 900 acres of developed and undeveloped land near Houston for $21,137,000 and $32,789,000 in real estate acquisitions principally located in various Texas markets. We received $10,461,000 in reimbursements from utility and improvement districts, of which $8,656,000 was related to our Cibolo Canyons project and was accounted for as a reduction of our investment. We paid $25,335,000 in federal and state income taxes, net of refunds.

In 2010, operating cash flow was adversely affected by lower operating income primarily due to difficult conditions in the housing industry and lower proceeds from the sale of assets in accordance with our 2009 strategic initiatives. Expenditures for real estate development were slightly less than non-cash cost of real estate sales due to a reduction in development. In 2010, we sold about 24,000 acres of timberland in Georgia, Alabama and Texas generating net proceeds of $38,040,000, of which $24,392,000 was held by a qualified intermediary under IRC Section 1031.

In 2009, the sale of about 95,000 acres of timberland in accordance with our 2009 strategic initiatives generated net proceeds of $153,851,000. Expenditures for real estate development slightly exceeded non-cash cost of sales due to our capital commitment to the resort at Cibolo Canyons and our development of existing real

estate projects, principally in the major markets of Texas. We invested $18,857,000 in Cibolo Canyons, of which $16,235,000 was invested in the resort development. We received $24,945,000 in reimbursements from utility and improvement districts, of which $20,270,000 was related to our Cibolo Canyons mixed-use development and was accounted for as a reduction of our investment. We paid estimated income taxes of $48,299,000 in 2009.

Cash Flows from Investing Activities

Capital contributions to and capital distributions from unconsolidated ventures, business acquisitions and investment in oil and natural gas properties and equipment are classified as investing activities. In addition, proceeds from the sale of property and equipment, software costs and expenditures related to reforestation activities are also classified as investing activities.

In 2011, net cash (used for) investing activities was ($4,895,000). We invested $4,304,000 in oil and natural gas properties and equipment associated with our non-operating working interests and $2,044,000 in property, equipment, software and reforestation. Net cash return of investment in our unconsolidated ventures was $1,060,000.

In 2010, net cash (used for) investing activities was ($26,597,000). In fourth quarter 2010, we acquired a 401 unit, Class A multifamily property in Houston, Texas for $49,100,000. We used $23,045,000 of the proceeds held by a qualified intermediary under Internal Revenue Code Section 1031 and $26,500,000 of non-recourse borrowings to fund this acquisition. In addition, we acquired a water resources company in central Texas for $12,000,000.

In 2009, net cash (used for) investing activities was ($6,373,000) and is principally related to our investment in property, equipment, software and reforestation. Net cash returned from our unconsolidated ventures provided $922,000.

Cash Flows from Financing Activities

In 2011, net cash (used for) financing activities was ($17,180,000) as we repurchased about 907,000 shares of our common stock for $12,977,000 and incurred $3,750,000 in deferred financing fees primarily related to supplementing and amending our senior secured credit facility.

In 2010, net cash (used for) financing activities was ($2,639,000) as we repurchased about 1,001,000 shares of our common stock for $15,178,000 and incurred $6,304,000 in bank fees primarily related to our amendment and extension of our senior credit facility, which was partially offset by a net increase in our debt of $18,170,000 which is principally due to $26,500,000 in non-recourse borrowings used to finance a 401 unit, Class A multifamily property acquired in fourth quarter 2010.

In 2009, net cash (used for) financing activities was ($122,823,000) as we reduced our outstanding debt by $120,776,000 principally from the net proceeds generated from the sale of about 95,000 acres of timberland in Georgia and Alabama.

Liquidity and Contractual Obligations

Liquidity

In 2011, we supplemented and amended our senior secured credit facility to provide us with, among other matters, additional flexibility with respect to the borrowing base, collateral coverage and leverage requirements. As a result, we increased our unused borrowing capacity and extended the maturity of our revolving line of credit by one year.

At year-end 2011, our senior secured credit facility provides for a $130,000,000 term loan maturing August 6, 2015 and a $200,000,000 revolving line of credit maturing August 6, 2014. Both the term loan and the revolving line of credit may be prepaid at any time without penalty. The revolving line of credit includes a $100,000,000 sublimit for letters of credit. Total borrowings under our senior secured credit facility (including the face amount of letters of credit) may not exceed a borrowing base formula. Our borrowing base availability is calculated on a monthly basis by applying advance rates of between 35 60% against borrowing base asset values which include timberland, high-value timberland (land in the entitlement process), raw entitled land, land under development, and

Table of Contents

minerals. All assets included in the borrowing base must be wholly-owned and unencumbered. At year-end 2011, net unused borrowing capacity under our senior credit facility is calculated as follows:

	Senior Credit Facility (In thousands)
Borrowing base availability	$ 288,446
Less: borrowings	(130,000)
Less: letters of credit	(2,318)
Unused borrowing capacity	$ 156,128

Our unused borrowing capacity during 2011 ranged from a high of $176,337,000 to a low of $94,872,000. This facility is used primarily to fund our operating cash needs, which fluctuate due to timing of residential real estate sales, undeveloped land sales, oil and natural gas royalty and mineral lease bonus payments, timber sales, payment of accounts payables and expenses and capital expenditures.

In third quarter 2011, we borrowed $15,400,000 which is collateralized by a 413 guest room hotel located in Austin, Texas with a carrying value of $21,569,000. This financing replaced debt retired in second quarter 2011.

Our senior credit facility and other debt agreements contain financial covenants customary for such agreements including minimum levels of interest coverage and limitations on leverage. At year-end 2011, we were in compliance with the financial covenants of these agreements.

The following table details our compliance with the financial covenants calculated as provided in the senior credit facility:

Financial Covenant	Requirement	Year-End 2011
Interest Coverage Ratio[(a)]	³1.05:1.0	6.23:1.0
Revenues/Capital Expenditures Ratio[(b)]	³1.00:1.0	2.18:1.0
Total Leverage Ratio[(c)]	£40%	24.9%
Net Worth[(d)]	³ $439 million	$504 million
Collateral Value to Loan Commitment Ratio[(e)]	³ 1.50:1.0	1.72:1.0

(a) Calculated as EBITDA (earnings before interest, taxes, depreciation and amortization), plus non-cash compensation expense, plus other non-cash expenses, divided by interest expense excluding loan fees. This covenant is applied at the end of each quarter on a rolling four quarter basis.

(b) Calculated as total gross revenues, plus our pro rata share of the operating revenues from unconsolidated ventures, divided by capital expenditures. Capital expenditures are defined as consolidated development and acquisition expenditures plus our pro rata share of unconsolidated ventures development and acquisition expenditures. This covenant is applied at the end of each quarter on a rolling four quarter basis.

(c) Calculated as total funded debt divided by adjusted asset value. Total funded debt includes indebtedness for borrowed funds, secured liabilities and reimbursement obligations with respect to letters of credit or similar instruments. Adjusted asset value is defined as the sum of unrestricted cash and cash equivalents, timberlands, high value timberlands, raw entitled lands, entitled land under development, minerals business, other real estate owned at book value without regard to any indebtedness and our pro rata share of joint ventures book value without regard to any indebtedness. This covenant is applied at the end of each quarter.

(d) Calculated as the amount by which consolidated total assets exceeds consolidated total liabilities. At year-end 2011, the requirement is $438,644,000 computed as: $438,644,000 plus 85 percent of the aggregate net proceeds received by us from any equity offering, plus 75 percent of all positive net income, on a cumulative basis. This covenant is applied at the end of each quarter.

(e) Calculated as the total collateral value of timberland, high value timberland and our minerals business, divided by total aggregate loan commitment. This covenant is applied at the end of each quarter.

To make additional investments, acquisitions, or distributions, we must maintain available liquidity equal to the lesser of $35,000,000 or 10% of the aggregate commitments in place. At year-end 2011, this requirement was $33,000,000 resulting in approximately $173,156,000 in available liquidity, which represents our unused borrowing capacity under our senior credit facility plus unrestricted cash and cash equivalents. The failure to maintain such minimum liquidity does not constitute a default or event of default of our senior credit facility.

Contractual Obligations

At year-end 2011, contractual obligations consist of:

		Payments Due or Expiring by Year			
	Total	**2012**	**2013-14**	**2015-16**	**Thereafter**
			(In thousands)		
Debt[a]	$ 221,587	$ 4,953	$ 55,317	$ 133,400	$ 27,917
Interest payments on debt	46,226	12,827	23,495	8,464	1,440
Purchase obligations	15,738	15,738			
Operating leases	21,710	2,531	4,538	3,923	10,718
Other commitments	540	540			
Total	$ 305,801	$ 36,589	$ 83,350	$ 145,787	$ 40,075

(a) Items included in our balance sheet.

Our sources of funding are our operating cash flows and borrowings under our senior credit facility. Our contractual obligations due in 2012 will likely be paid from operating cash flows and from borrowings under our senior credit facility.

Interest payments on debt include interest payments related to our fixed rate debt and estimated interest payments related to our variable rate debt. Estimated interest payments on variable rate debt were calculated assuming that the outstanding balances and interest rates that existed at year-end 2011 remain constant through maturity.

Purchase obligations are defined as legally binding and enforceable agreements to purchase goods and services. Our purchase obligations include commitments for land acquisition and land development, engineering and construction contracts for development and service contracts. In 2011, we began construction on a 289 unit multifamily project in Austin in which the estimated total cost, including land, is approximately $30,536,000. At year-end 2011, our investment in this project is $13,428,000 and the total cost to complete construction is $17,108,000, which includes both contracted and un-contracted costs.

Our operating leases are for timberland, facilities, equipment and groundwater. In 2008, we entered into a 10-year agreement to lease approximately 32,000 square feet in Austin, Texas as our corporate headquarters. At year-end 2011, the remaining contractual obligation is $8,839,000. Also included in operating leases is a long-term timber lease of over 16,000 acres that has a remaining lease term of 14 years and a remaining contractual obligation of $10,224,000 and about 17,800 acres of groundwater leases with remaining contractual obligations of $627,000.

We have other long-term liabilities that are not included in the table because they do not have scheduled maturities.

Table of Contents

Off-Balance Sheet Arrangements

From time to time, we enter into off-balance sheet arrangements to facilitate our operating activities. At year-end 2011, our off-balance sheet unfunded arrangements, excluding contractual interest payments, purchase obligations, operating lease obligations and venture contributions included in the table of contractual obligations, consist of:

		Payments Due or Expiring by Year			
	Total	2012	2013-14	2015-16	Thereafter
		(In thousands)			
Performance bonds	$ 4,598	$ 4,335	$ 243	$ 20	$
Standby letters of credit	2,318	984	1,334		
Recourse obligations	3,178	551	1,282	90	1,255
Total	$ 10,094	$ 5,870	$ 2,859	$ 110	$ 1,255

Performance bonds, letters of credit and recourse obligations are primarily for our real estate development activities and include $1,428,000 of performance bonds and letters of credit we provided on behalf of certain ventures. Our venture partners also provide performance bonds and letters of credit. Generally these performance bonds or letters of credit would be drawn on due to lack of specific performance by us or the ventures, such as failure to deliver streets and utilities in accordance with local codes and ordinances.

At year-end 2011, we participate in three partnerships that have total assets of $49,799,000 and total liabilities of $79,623,000, which includes $63,353,000 of borrowings classified as current maturities. These partnerships are managed by third parties who intend to extend or refinance these borrowings; however, there is no assurance that this can be done. Although these borrowings are guaranteed by third parties, we may under certain circumstances elect or be required to provide additional equity to these partnerships. We do not believe that the ultimate resolution of these matters will have a significant effect on our earnings or financial position. Our investment in these partnerships is $2,108,000 at year-end 2011. These three partnerships are variable interest entities.

Cibolo Canyons San Antonio, Texas

Cibolo Canyons consists of the JW Marriott® San Antonio Hill Country Resort & Spa development owned by third parties and a mixed-use development we own. We have about $80,431,000 invested in Cibolo Canyons at year-end 2011.

Resort Hotel, Spa and Golf Development

In 2007, we entered into agreements to facilitate third-party construction and ownership of the JW Marriott ® San Antonio Hill Country Resort & Spa, which includes a 1,002 room destination resort and two PGA Tour ® Tournament Players Club ® (TPC) golf courses. Under these agreements, we agreed to transfer to third-party owners 700 acres of undeveloped land, to provide $30,000,000 cash and to provide $12,700,000 of other consideration principally consisting of golf course construction materials, substantially all of which has been provided.

In exchange for our commitment to the resort, the third-party owners assigned to us certain rights under an agreement between the third-party owners and a legislatively created Special Improvement District (SID). This agreement includes the right to receive from the SID 9 percent of hotel occupancy revenues and 1.5 percent of other resort sales revenues collected as taxes by the SID through 2034. The amount we receive will be net of annual ad valorem tax reimbursements by the SID to the third-party owners of the resort through 2020. In addition, these payments will be net of debt service, if any, on bonds issued by the SID collateralized by hotel occupancy tax and other resort sales tax through 2034.

The amounts we collect under this agreement are dependent on several factors including the amount of revenues generated by and ad valorem taxes imposed on the resort and the amount of any applicable debt service

Table of Contents

incurred by the SID. As a result, there is significant uncertainty as to the amount and timing of collections under this agreement. Until these uncertainties are clarified, amounts collected under the agreement will be accounted for as a reduction of our investment in the resort development. The resort began operations on January 2010.

In 2011, we received $6,906,000 related to our share of hotel occupancy revenues and other resort sales revenues collected as taxes by the SID. Since inception, we have received $7,906,000 in reimbursements and have accounted for this as a reduction of our investment. At year-end 2011, we have $35,368,000 invested in the resort development.

Mixed-Use Development

The mixed-use development we own consists of 2,100 acres planned to include about 1,475 residential lots and about 150 commercial acres designated for multifamily and retail uses, of which 697 lots and 68 commercial acres have been sold through year-end 2011.

In 2007, we entered into an agreement with the SID providing for reimbursement of certain infrastructure costs related to the mixed-use development. Reimbursements are subject to review and approval by the SID and unreimbursed amounts accrue interest at 9.75 percent. The SID s funding for reimbursements is principally derived from its ad valorem tax collections and bond proceeds collateralized by ad valorem taxes, less debt service on these bonds and annual administrative and public service expenses.

Because the amount of each reimbursement is dependent on several factors, including timing of SID approval and the SID having an adequate tax base to generate funds that can be used to reimburse us, there is uncertainty as to the amount and timing of reimbursements under this agreement. We expect to recover our investment from lot and tract sales and reimbursement of approved infrastructure costs from the SID. We have not recognized income from interest due, but not collected. As these uncertainties are clarified, we will modify our accounting accordingly.

Through year-end 2011, we have submitted and received approval for reimbursement of about $57,322,000 of infrastructure costs and have received reimbursements totaling $22,520,000, of which $1,750,000 was received in 2011, $500,000 in 2010 and $20,270,000 in 2009, all were accounted for as a reduction of our investment in the mixed-use development. At year-end 2011, we have $34,802,000 in approved and pending reimbursements, excluding interest. At year-end 2011, we have $45,063,000 invested in the mixed-use development.

Accounting Policies

Critical Accounting Estimates

In preparing our financial statements, we follow generally accepted accounting principles, which in many cases require us to make assumptions, estimates, and judgments that affect the amounts reported. Our significant accounting policies are included in Note 1 to the Consolidated Financial Statements. Many of these principles are relatively straightforward. There are, however, a few accounting policies that are critical because they are important in determining our financial condition and results of operations and involve significant assumptions, estimates and judgments that are difficult to determine. We must make these assumptions, estimates and judgments currently about matters that are inherently uncertain, such as future economic conditions, operating results and valuations, as well as our intentions. As the difficulty increases, the level of precision decreases, meaning actual results can, and probably will, differ from those currently estimated. We base our assumptions, estimates and judgments on a combination of historical experiences and other factors that we believe are reasonable. We have reviewed the selection and disclosure of these critical accounting estimates with our Audit Committee.

Investment in Real Estate and Cost of Real Estate Sales In allocating costs to real estate owned and real estate sold, we must estimate current and future real estate values. Our estimates of future real estate values sometimes must extend over periods 15 to 20 years from today and are dependent on numerous

assumptions including our intentions and future market and economic conditions. In addition, when we sell real estate from projects that are not finished, we must estimate future development costs through completion. Differences between our estimates and actual results will affect future carrying values and operating results.

Impairment of Long-Lived Assets Measuring assets for impairment requires estimating future fair values based on our intentions as to holding periods, future operating cash flows and the residual value of assets under review, primarily undeveloped land. Depending on the asset under review, we use varying methods to determine fair value, such as discounting expected future cash flows, determining resale values by market, or applying a capitalization rate to net operating income using prevailing rates in a given market. Changes in economic conditions, demand for real estate, and the projected net operating income for a specific property will inevitably change our estimates.

Share-Based Compensation We use the Black-Scholes option pricing model to determine the fair value of stock options. The determination of the fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the stock price as well as assumptions regarding a number of other variables. These variables include expected stock price volatility over the term of the awards, actual and projected employee stock option exercise behaviors (term of option), risk-free interest rate and expected dividends. We have limited historical experience as a stand-alone company so we utilized alternative methods in determining our valuation assumptions. The expected life was based on the simplified method utilizing the midpoint between the vesting period and the contractual life of the awards. In 2011, the expected stock price volatility was based on a blended rate utilizing our historical volatility and historical prices of our peers common stock for a period corresponding to the expected life of the options. In 2010 and 2009, the expected stock price volatility was based on historical prices of our peers common stock for a period corresponding to the expected life of the options. Pre-vesting forfeitures are estimated based upon the pool of participants and their expected activity and historical trends.

Income Taxes In preparing our consolidated financial statements, significant judgment is required to estimate our income taxes. Our estimates are based on our interpretation of federal and state tax laws. We estimate our actual current tax due and assess temporary and permanent differences resulting from differing treatment of items for tax and accounting purposes. The temporary differences result in deferred tax assets and liabilities, which are included in our consolidated balance sheet. If needed, we record a valuation allowance against our deferred tax assets. In addition, when we believe a tax position is supportable but the outcome uncertain, we include the item in our tax return but do not recognize the related benefit in our provision for taxes. Instead, we record a reserve for unrecognized tax benefits, which represents our expectation of the most likely outcome considering the technical merits and specific facts of the position. Changes to liabilities are only made when an event occurs that changes the most likely outcome, such as settlement with the relevant tax authority, expiration of statutes of limitations, changes in tax law, or recent court rulings. Adjustments to temporary differences, permanent differences or uncertain tax positions could materially impact our financial position, cash flow and results of operation.

Oil and Natural Gas Reserves The estimation of oil and natural gas reserves is a significant estimate. On an annual basis, our consulting petroleum engineering firm, with our assistance, prepares estimates of crude oil and natural gas reserves based on available geologic and seismic data, reservoir pressure data, core analysis reports, well logs, analogous reservoir performance history, production data and other available sources of engineering, geological and geophysical information. Oil and natural gas prices are volatile and largely affected by worldwide or domestic production and consumption and are outside our control.

Adopted and Pending Accounting Pronouncements

We adopted three new accounting pronouncements in 2011, the adoption of which did not have a significant effect on our earnings or financial position. There are three pending accounting pronouncements that we will be required to adopt in 2012 and adoption is not anticipated to have a significant effect on our earnings or financial position. Please read Note 2 New Accounting Pronouncements to the Consolidated Financial Statements.

Table of Contents

Effects of Inflation

Inflation has had minimal effects on operating results the past three years. Our real estate, timber, and property and equipment are carried at historical costs. If carried at current replacement costs, the cost of real estate sold, timber cut, and depreciation expense would have been significantly higher than what we reported.

Legal Proceedings

We are involved in various legal proceedings that arise from time to time in the ordinary course of doing business. We believe we have established adequate reserves for any probable losses, and we do not believe that the outcome of any of these proceedings should have a material adverse effect on our financial position, long-term results of operations, or cash flow. It is possible, however, that charges related to these matters could be significant to results of operations or cash flows in any one accounting period.

Item 7A. ***Quantitative and Qualitative Disclosures About Market Risk.***
Interest Rate Risk

Our interest rate risk is principally related to our variable-rate debt. Interest rate changes impact earnings due to the resulting increase or decrease in our variable-rate debt, which was $191,656,000 at year-end 2011 and $191,658,000 at year-end 2010.

The following table illustrates the estimated effect on our pre-tax income of immediate, parallel, and sustained shifts in interest rates for the next 12 months on our variable-rate debt at year-end 2011, with comparative year-end 2010 information. This estimate assumes that debt reductions from contractual payments will be replaced with short-term, variable-rate debt; however, that may not be the financing alternative we choose.

	At Year-End	
Change in Interest Rates	**2011**	**2010**
	(In thousands)	
+2%	$ (3,296)	$ (3,728)
+1%	(1,917)	(1,917)
-1%	1,917	1,917
-2%	3,833	3,833

Foreign Currency Risk

We have no exposure to foreign currency fluctuations.

Commodity Price Risk

We have no significant exposure to commodity price fluctuations.

Table of Contents

Item 8. ***Financial Statements and Supplementary Data.***

Index to Financial Statements

	Page
Management s Annual Report on Internal Control over Financial Reporting	58
Report of Independent Registered Public Accounting Firm	59
Report of Independent Registered Public Accounting Firm	60
Audited Financial Statements	
Consolidated Balance Sheets	61
Consolidated Statements of Income	62
Consolidated Statements of Shareholders Equity	63
Consolidated Statements of Cash Flows	64
Notes to the Consolidated Financial Statements	65
Financial Statement Schedule	
Schedule III Consolidated Real Estate and Accumulated Depreciation	92

Table of Contents

MANAGEMENT S ANNUAL REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of Forestar is responsible for establishing and maintaining adequate internal control over financial reporting. Management has designed our internal control over financial reporting to provide reasonable assurance that our published financial statements are fairly presented, in all material respects, in conformity with generally accepted accounting principles.

Management is required by paragraph (c) of Rule 13a-15 of the Securities Exchange Act of 1934, as amended, to assess the effectiveness of our internal control over financial reporting as of each year end. In making this assessment, management used the *Internal Control Integrated Framework* issued in July 1994 by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Management conducted the required assessment of the effectiveness of our internal control over financial reporting as of year-end. Based upon this assessment, management believes that our internal control over financial reporting is effective as of year-end 2011.

Ernst & Young LLP, the independent registered public accounting firm that audited our financial statements included in this Form 10-K, has also audited our internal control over financial reporting. Their attestation report follows this report of management.

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of Forestar Group Inc.:

We have audited Forestar Group Inc. and subsidiaries (Forestar Group) internal control over financial reporting as of December 31, 2011 based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Forestar Group s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management s Annual Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the effectiveness of the company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

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

In our opinion, Forestar Group maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Forestar Group as of December 31, 2011 and December 31, 2010 and the related consolidated statements of income, shareholders equity, and cash flows for each of the three years ended December 31, 2011 and our report dated March 7, 2012 expressed an unqualified opinion thereon.

Ernst & Young LLP

Austin, Texas

March 7, 2012

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of Forestar Group Inc.:

We have audited the accompanying consolidated balance sheets of Forestar Group Inc. and subsidiaries (Forestar Group) as of December 31, 2011 and December 31, 2010, and the related consolidated statements of income, shareholders equity, and cash flows for each of the three years ended December 31, 2011. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Forestar Group at December 31, 2011 and December 31, 2010, and the consolidated results of their operations and their cash flows for each of the three years ended December 31, 2011, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Forestar Group s internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 7, 2012 expressed an unqualified opinion thereon.

Ernst & Young LLP

Austin, Texas

March 7, 2012

Table of Contents

FORESTAR GROUP INC.

CONSOLIDATED BALANCE SHEETS

	At Year-End 2011	2010
	(In thousands, except share data)	
ASSETS		
Cash and cash equivalents	$ 18,283	$ 5,366
Real estate	565,367	561,652
Assets held for sale		21,122
Investment in unconsolidated ventures	64,223	101,166
Timber	14,240	17,959
Receivables, net of allowance for bad debts of $62 in 2011 and $144 in 2010	23,281	3,415
Prepaid expenses	2,931	2,034
Property and equipment, net of accumulated depreciation of $5,164 in 2011 and $4,271 in 2010	5,178	5,577
Oil and natural gas properties and equipment, net of accumulated depletion of $155 in 2011 and $134 in 2010	4,561	322
Deferred tax asset	72,942	47,141
Goodwill and other intangible assets	5,451	6,527
Other assets	18,400	17,043
TOTAL ASSETS	$ 794,857	$ 789,324
LIABILITIES AND SHAREHOLDERS EQUITY		
Accounts payable	$ 5,044	$ 4,214
Accrued employee compensation and benefits	1,421	994
Accrued property taxes	4,986	3,662
Accrued interest	1,086	1,061
Income taxes payable	8,501	3,293
Other accrued expenses	7,716	8,168
Other liabilities	33,304	32,064
Debt	221,587	221,589
TOTAL LIABILITIES	283,645	275,045
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS EQUITY		
Forestar Group Inc. shareholders equity:		
Preferred stock, par value $0.01 per share, 25,000,000 authorized shares, none issued		
Common stock, par value $1.00 per share, 200,000,000 authorized shares, 36,835,732 issued at December 31, 2011 and 36,667,210 issued at December 31, 2010	36,836	36,667
Additional paid-in capital	398,517	391,352
Retained earnings	108,155	101,001
Treasury stock, at cost, 2,212,876 shares at December 31, 2011 and 1,216,647 shares at December 31, 2010	(33,982)	(19,456)
Total Forestar Group Inc. shareholders equity	509,526	509,564
Noncontrolling interests	1,686	4,715
TOTAL SHAREHOLDERS EQUITY	511,212	514,279
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 794,857	$ 789,324

Please read the notes to the consolidated financial statements.

Table of Contents

FORESTAR GROUP INC.

CONSOLIDATED STATEMENTS OF INCOME

	For the Year		
	2011	2010	2009
	(In thousands, except per share amounts)		
REVENUES			
Real estate sales	$ 77,839	$ 45,003	$ 75,050
Income producing properties and other	28,329	23,266	19,386
Real estate	106,168	68,269	94,436
Mineral resources	24,584	24,790	36,256
Fiber resources and other	4,821	8,301	15,559
	135,573	101,360	146,251
EXPENSES			
Cost of real estate sales	(44,913)	(27,488)	(30,463)
Cost of income producing properties and other	(18,062)	(17,997)	(15,043)
Cost of mineral resources	(2,918)	(1,097)	(922)
Cost of fiber resources	(1,072)	(1,640)	(3,396)
Other operating	(48,951)	(40,279)	(45,486)
General and administrative	(23,326)	(22,581)	(29,926)
Gain on sale of assets	61,784	28,607	104,047
	(77,458)	(82,475)	(21,189)
OPERATING INCOME	58,115	18,885	125,062
Equity in earnings (loss) of unconsolidated ventures	(29,209)	4,701	(7,771)
Interest expense	(17,012)	(16,446)	(20,459)
Other non-operating income	368	1,164	375
INCOME BEFORE TAXES	12,262	8,304	97,207
Income tax expense	(3,021)	(2,470)	(35,633)
CONSOLIDATED NET INCOME	9,241	5,834	61,574
Less: Net income attributable to noncontrolling interests	(2,087)	(709)	(2,467)
NET INCOME ATTRIBUTABLE TO FORESTAR GROUP INC.	$ 7,154	$ 5,125	$ 59,107
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING			
Basic	35,413	35,893	35,890
Diluted	35,781	36,377	36,102
NET INCOME PER COMMON SHARE			
Basic	$ 0.20	$ 0.14	$ 1.65
Diluted	$ 0.20	$ 0.14	$ 1.64

Please read the notes to the consolidated financial statements.

62

Table of Contents

FORESTAR GROUP INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

		Forestar Group Inc. Shareholders							
		Common Stock		Additional Paid-in	Treasury Stock		Accumulated Other Comprehensive	Retained	Noncontrolling
	Total	Shares	Amount	Capital	Shares	Amount	Income	Earnings	Interest
	(In thousands, except share data)								
Balances at December 31, 2008	$ 453,952	35,839,390	$ 35,839	$ 377,810	(90,819)	$ (1,866)	$ (1,260)	$ 36,769	$ 6,660
Net income	61,574							59,107	2,467
Unrealized gain on interest rate swap, net of taxes of ($542)	1,004						1,004		
Comprehensive income	$ 62,578								
Distributions to noncontrolling interest	(3,501)								(3,501)
Contributions from noncontrolling interest	253								253
Issuances of common stock		4,870	5	(5)					
Issuances of restricted stock		125,275	125	(125)					
Issuances from exercises of stock options	3,547	285,801	286	3,261					
Shares withheld for payroll taxes	(467)				(24,170)	(467)			
Shares exchanged for options exercised	(1,880)				(93,255)	(1,880)			
Forfeitures of restricted stock				1	(1,300)	(1)			
Share-based compensation	3,824			3,824					
Tax benefit from exercise of restricted stock units and stock options and vested restricted stock	29			29					
Balances at December 31, 2009	$ 518,335	36,255,336	$ 36,255	$ 384,795	(209,544)	$ (4,214)	$ (256)	$ 95,876	$ 5,879
Net income	5,834							5,125	709
Unrealized gain on interest rate swap, net of taxes of ($137)	256						256		
Comprehensive income	$ 6,090								
Distributions to noncontrolling interest	(2,690)								(2,690)
Contributions from noncontrolling interest	817								817
Issuances of common stock		2,585	3	(3)					
Issuances of restricted stock		308,697	309	(309)					
Issuances from exercises of stock options	1,199	91,078	91	1,108					
Issuances from restricted stock units	165	9,514	9	156					
Shares withheld for payroll taxes	(7)				(389)	(7)			
Shares exchanged for options exercised	(54)				(2,858)	(54)			
Shares repurchased	(15,178)				(1,000,987)	(15,178)			
Forfeitures of restricted stock				3	(2,869)	(3)			
Share-based compensation	5,572			5,572					
Tax benefit from exercise of restricted stock units and stock options and vested restricted stock	30			30					

Balances at December 31, 2010	$ 514,279	36,667,210	$ 36,667	$ 391,352	(1,216,647)	$ (19,456)	$	$ 101,001	$ 4,715
Net income	9,241							7,154	2,087
Distributions to noncontrolling interest	(5,259)								(5,259)
Contributions from noncontrolling interest	143								143
Issuances of common stock		1,347	1	(1)					
Issuances of restricted stock		39,595	40	(40)					
Issuances from exercises of stock options	1,470	127,580	128	1,342					
Shares withheld for payroll taxes	(1,367)				(77,562)	(1,367)			
Shares exchanged for options exercised	(180)				(9,795)	(180)			
Shares repurchased	(12,977)				(906,708)	(12,977)			
Forfeitures of restricted stock				2	(2,164)	(2)			
Share-based compensation	5,972			5,972					
Tax benefit from exercise of restricted stock units and stock options and vested restricted stock	(110)			(110)					
Balances at December 31, 2011	$ 511,212	36,835,732	$ 36,836	$ 398,517	(2,212,876)	$ (33,982)	$	$ 108,155	$ 1,686

Please read the notes to the consolidated financial statements.

Table of Contents

FORESTAR GROUP INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Year		
	2011	2010	2009
	(In thousands)		
CASH FLOWS FROM OPERATING ACTIVITIES:			
Consolidated net income	$ 9,241	$ 5,834	$ 61,574
Adjustments:			
Depreciation, depletion and amortization	9,812	9,014	9,786
Deferred income taxes	(27,177)	(6,527)	(22,734)
Tax benefits not recognized for book purposes	(147)	133	6,162
Equity in (earnings) loss of unconsolidated ventures	29,209	(4,701)	7,771
Distributions of earnings of unconsolidated ventures	6,597	1,609	259
Distributions of earnings to noncontrolling interests	(4,860)	(1,881)	(3,325)
Non-cash share-based compensation	7,067	11,596	11,998
Non-cash real estate cost of sales	34,137	18,261	25,858
Non-cash cost of assets sold	24,931	9,503	49,804
Proceeds reinvested through qualified intermediary		(23,045)	
Real estate development and acquisition expenditures	(66,997)	(16,660)	(33,787)
Acquisition of non-performing loan	(21,137)		
Reimbursements from utility and improvement districts	10,461	4,752	24,945
Other changes in real estate	(284)	179	384
Gain on termination of timber lease	(181)	(671)	(195)
Cost of timber cut	990	1,544	3,104
Deferred income	32	1,307	(2,673)
Asset impairments	11,525	9,042	7,931
Loss on sale of assets held for sale	47	277	
Other	73	(16)	528
Changes in:			
Notes and accounts receivables	1,359	104	(747)
Proceeds due from qualified intermediary		(1,347)	
Prepaid expenses and other	536	1,154	1,259
Accounts payable and other accrued liabilities	4,549	(6,394)	(8,490)
Income taxes	5,209	484	2,708
Net cash provided by (used for) operating activities	34,992	13,551	142,120
CASH FLOWS FROM INVESTING ACTIVITIES:			
Property, equipment, software and reforestation	(2,044)	(2,701)	(7,295)
Oil and natural gas properties and equipment	(4,304)	(1)	
Investment in unconsolidated ventures	(2,007)	(3,291)	(2,875)
Return of investment in unconsolidated ventures	3,067	14,849	3,797
Business acquisitions, net of cash acquired		(38,055)	
Proceeds from sale of assets held for sale	103	2,602	
Proceeds from termination of timber lease	290		
Net cash (used for) investing activities	(4,895)	(26,597)	(6,373)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Payments of debt	(123,399)	(63,420)	(164,612)
Additions to debt	123,397	81,590	43,836
Deferred financing fees	(3,750)	(6,304)	(3,209)
Return of investment to noncontrolling interest	(407)	(809)	(176)
Exercise of stock options	1,470	1,199	3,547
Repurchases of common stock	(12,977)	(15,178)	
Payroll taxes on restricted stock and stock options	(1,547)	(61)	(2,347)
Tax benefit from share-based compensation	(110)	30	29
Other	143	314	109
Net cash (used for) provided by financing activities	(17,180)	(2,639)	(122,823)

Net (decrease) increase in cash and cash equivalents	12,917	(15,685)	12,924
Cash and cash equivalents at beginning of year	5,366	21,051	8,127
Cash and cash equivalents at year-end	$ 18,283	$ 5,366	$ 21,051
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:			
Cash paid during the year for:			
Interest	$ 14,166	$ 11,889	$ 16,951
Income taxes	$ 25,335	$ 8,423	$ 48,299
SUPPLEMENTAL DISCLOSURE OF NON-CASH INFORMATION:			
Capitalized interest	$ 625	$ 75	$ 1,021
SUPPLEMENTAL DISCLOSURE OF BUSINESS ACQUISITIONS INFORMATION:			
Proceeds reinvested through qualified intermediary under IRC Section 1031	$	$ 23,045	$
Proceeds provided by financing activities		38,055	
Total business acquisitions	$	$ 61,100	$

Please read the notes to the consolidated financial statements.

FORESTAR GROUP INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Summary of Significant Accounting Policies

Basis of Presentation

Our consolidated financial statements include the accounts of Forestar Group Inc., all subsidiaries, ventures, and other entities in which we have a controlling interest and variable interest entities of which we are the primary beneficiary. We eliminate all material intercompany accounts and transactions. Noncontrolling interests in consolidated pass-through entities are recognized before income taxes. We account for our investment in other entities in which we have significant influence over operations and financial policies using the equity method (we recognize our share of the entities income or loss and any preferential returns and treat distributions as a reduction of our investment). We account for our investment in other entities in which we do not have significant influence over operations and financial policies using the cost method (we recognize as income only distribution of accumulated earnings).

We prepare our financial statements in accordance with generally accepted accounting principles, which require us to make estimates and assumptions about future events. Actual results can, and probably will, differ from those we currently estimate. Examples of significant estimates include those related to allocating costs to real estate and measuring assets for impairment.

Cash and Cash Equivalents

Cash and cash equivalents include cash and other short-term instruments with original maturities of three months or less. Restricted cash included in cash and cash equivalents was $1,255,000 at year-end 2011 and $773,000 at year-end 2010.

Cash Flows

Expenditures for the acquisition and development of real estate are classified as operating activities. Expenditures for the acquisition of income producing properties, investment in oil and natural gas properties and equipment, and business acquisitions are classified as investing activities.

Capitalized Software

We capitalize purchased software costs as well as the direct internal and external costs associated with software we develop for our own use. We amortize these capitalized costs using the straight-line method over estimated useful lives ranging from three to seven years. The carrying value of capitalized software was $2,176,000 at year-end 2011 and $2,823,000 at year-end 2010 and is included in other assets. The amortization of these capitalized costs was $1,493,000 in 2011, $1,206,000 in 2010 and $1,012,000 in 2009 and is included in general and administrative and operating expenses.

Derivative Instruments

We periodically enter into interest rate agreements in the normal course of business to mitigate the risk inherent in interest rate fluctuations. We do not enter into derivative instruments for trading purposes. We defer and include in other comprehensive income changes in the fair value of derivative instruments designated as cash flow hedges. We recognize the ineffective portion of these hedges in income or loss. The effectiveness of the hedge relationship is periodically assessed by comparing the present value of the cumulative change in the expected future cash flows on the variable leg of the swap with the present value of the cumulative change in the expected future hedged cash flows.

Environmental and Asset Retirement Obligations

We recognize environmental remediation liabilities on an undiscounted basis when environmental assessments or remediation are probable and we can reasonably estimate the cost. We adjust these liabilities as further information is obtained or circumstances change. We currently do not have any asset retirement obligations.

Fair Value Measurements

Financial instruments for which we did not elect the fair value option include cash and cash equivalents, accounts and notes receivables, other current assets, long-term debt, accounts payable and other current liabilities. With the exception of long-term notes receivable and debt, the carrying amounts of these financial instruments approximate their fair values due to their short-term nature or variable interest rates.

Goodwill and Other Intangible Assets

We record goodwill when the purchase price of a business acquisition exceeds the estimated fair value of net identified tangible and intangible assets acquired. We do not amortize goodwill or other indefinite lived intangible assets. Instead, we measure these assets for impairment based on the estimated fair values at least annually or more frequently if impairment indicators exist. We perform the annual impairment measurement as of the beginning of the fourth quarter of each year. Intangible assets with finite useful lives are amortized over their estimated useful lives.

Impairment of Long-Lived Assets

We review long-lived assets held for use, principally real estate, for impairment when events or circumstances indicate that their carrying value may not be recoverable. Impairment exists if the carrying amount of the long-lived asset is not recoverable from the undiscounted cash flows expected from its use and eventual disposition. We determine the amount of the impairment loss by comparing the carrying value of the long-lived asset to its estimated fair value. In the absence of quoted market prices, we determine estimated fair value generally based on the present value of future probability weighted cash flows expected from the sale of the long-lived asset. Non-cash impairment charges related to our owned and consolidated real estate assets are included in cost of real estate sales.

Income Taxes

We provide deferred income taxes using current tax rates for temporary differences between the financial accounting carrying value of assets and liabilities and their tax accounting carrying values. We recognize and value income tax exposures for the various taxing jurisdictions where we operate based on laws, elections, commonly accepted tax positions, and management estimates. We include tax penalties and interest in income tax expense. We provide a valuation allowance for any deferred tax asset that is not likely to be recoverable in future periods.

When we believe a tax position is supportable but the outcome uncertain, we include the item in our tax return but do not recognize the related benefit in our provision for taxes. Instead, we record a reserve for unrecognized tax benefits, which represents our expectation of the most likely outcome considering the technical merits and specific facts of the position. Changes to liabilities are only made when an event occurs that changes the most likely outcome, such as settlement with the relevant tax authority, expiration of statutes of limitations, changes in tax law, or recent court rulings.

Mineral Interests

We acquire real estate that may include the subsurface rights associated with the property, including minerals. We capitalize the costs of acquiring these mineral interests. We amortize the cost assigned to unproved interests, principally acquisition costs, using the straight-line method over appropriate periods based on our experience, generally no longer than 10 years. Costs assigned to individual unproven interests are minimal and amortized on an aggregate basis. When we lease these interests to third-party oil and natural gas exploration and production entities, any related unamortized costs are accounted for using the cost recovery method from the cash proceeds received from lease bonus payments.

When we lease our mineral interests to third-party exploration and production entities, we retain a royalty interest and may take an additional participation in production, including a non-operating working interest. Non-operating working interests refer to well interests in which we pay a share of the costs to drill, complete and operate a well and receive a proportionate share of the production revenues. We use the successful efforts method to account for our mineral interest participations. Mineral interests and non-operating working interests, net of

amortization, are included in oil and natural gas properties and equipment on our balance sheet. We amortize our capitalized non-operating working interests as well as acquisition of proven properties based on the units of production depletion method.

Operating Leases

We occupy office space in various locations under operating leases. The lease agreements may contain rent escalation clauses, construction allowances and/or contingent rent provisions. We expense operating leases ratably over the shorter of the useful life or the lease term. For scheduled rent escalation clauses, we recognize the base rent expense on a straight-line basis and record the difference between the recognized rent expense and the amounts payable under the lease as deferred lease credits included in other liabilities in the consolidated balance sheets. Deferred lease credits are amortized over the lease term. For construction allowances, we record leasehold improvement assets included in property and equipment in the consolidated balance sheets amortized over the shorter of their economic lives or the lease term. The related deferred lease credits are amortized as a reduction of rent expense over the lease term.

Property and Equipment

We carry property and equipment at cost less accumulated depreciation. We capitalize the cost of significant additions and improvements, and we expense the cost of repairs and maintenance. We capitalize interest costs incurred on major construction projects. We depreciate these assets using the straight-line method over their estimated useful lives as follows:

	Estimated Useful Lives	Carrying Value Year-End 2011	2010
		(In thousands)	
Buildings and building improvements	10 to 40 years	$ 4,916	$ 4,417
Property and equipment	2 to 10 years	5,426	5,431
		10,342	9,848
Less: accumulated depreciation		(5,164)	(4,271)
		$ 5,178	$ 5,577

Depreciation expense of property and equipment was $893,000 in 2011, $890,000 in 2010 and $1,022,000 in 2009.

Real Estate

We carry real estate at the lower of cost or fair value less cost to sell. We capitalize interest costs once development begins, and we continue to capitalize throughout the development period. We also capitalize infrastructure, improvements, amenities, and other development costs incurred during the development period. We determine the cost of real estate sold using the relative sales value method. When we sell real estate from projects that are not finished, we include in the cost of real estate sold estimates of future development costs through completion, allocated based on relative sales values. These estimates of future development costs are reevaluated at least annually, with any adjustments being allocated prospectively to the remaining units available for sale.

Income producing properties are carried at cost less accumulated depreciation computed using the straight-line method over their estimated useful lives.

We have agreements with utility or improvement districts, principally in Texas, whereby we agree to convey to the districts water, sewer and other infrastructure-related assets we have constructed in connection with projects within their jurisdiction. The reimbursement for these assets ranges from 70 to 100 percent of allowable cost as defined by the district. The transfer is consummated and we receive payment when the districts have a sufficient tax base to support funding of their bonds. The cost we incur in constructing these assets is included in

capitalized development costs, and upon collection, we remove the assets from capitalized development costs. We provide an allowance to reflect our past experiences related to claimed allowable development costs.

Reclassifications

In 2011, we reclassified $1,612,000 in assets held for sale to real estate and timber upon completing our 2009 strategic initiatives related to the sale of higher and better use timberland.

Revenue

Real Estate

We recognize revenue from sales of real estate when a sale is consummated, the buyer s initial investment is adequate, any receivables are probable of collection, the usual risks and rewards of ownership have been transferred to the buyer, and we do not have significant continuing involvement with the real estate sold. If we determine that the earnings process is not complete, we defer recognition of any gain until earned. We recognize revenue from hotel room sales and other guest services when rooms are occupied and other guest services have been rendered. We recognize revenue from our multifamily properties when payments are due from residents, generally on a monthly basis.

We exclude from revenue amounts we collect from utility or improvement districts related to the conveyance of water, sewer and other infrastructure related assets. We also exclude from revenue amounts we collect for timber sold on land being developed. These proceeds reduce capitalized development costs. We exclude from revenue amounts we collect from customers that represent sales tax or other taxes that are based on the sale. These amounts are included in other accrued expenses until paid.

Mineral Resources

We recognize revenue from mineral bonus payments when we have received an executed agreement with the exploration company transferring the rights to any oil or natural gas it may find and requiring drilling be done within a specified period, the payment has been collected, and we have no obligation to refund the payment. We recognize revenue from delay rentals if drilling has not started within the specified period and when the payment has been collected. We recognize revenue from mineral royalties and non-operating working interests when the minerals have been delivered to the buyer, the value is determinable, and we are reasonably sure of collection.

Fiber Resources

We recognize revenue from timber sales upon passage of title, which occurs at delivery; when the price is fixed and determinable; and we are reasonably sure of collection. We recognize revenue from recreational leases on the straight-line basis over the lease term if we are reasonably sure of collection.

Share-Based Compensation

We use the Black-Scholes option pricing model for stock options, Monte Carlo simulation pricing model for market-leveraged stock units, grant date fair value for equity-settled awards and period-end fair value for cash-settled awards. We expense share-based awards ratably over the vesting period or earlier based on retirement eligibility.

Timber

We carry timber at cost less the cost of timber cut. We expense the cost of timber cut based on the relationship of the timber carrying value to the estimated volume of recoverable timber multiplied by the amount of timber cut. We include the cost of timber cut in cost of fiber resources in the income statement. We determine the estimated volume of recoverable timber using statistical information and other data related to growth rates and yields gathered from physical observations, models and other information gathering techniques. Changes in yields are generally due to adjustments in growth rates and similar matters and are accounted for prospectively as changes in estimates. We capitalize reforestation costs incurred in developing viable seedling plantations (up to two years from planting), such as site preparation, seedlings, planting, fertilization, insect and wildlife control,

Table of Contents

and herbicide application. We expense all other costs, such as property taxes and costs of forest management personnel, as incurred. Once the seedling plantation is viable, we expense all costs to maintain the viable plantations, such as fertilization, herbicide application, insect and wildlife control, and thinning, as incurred.

Note 2 New and Pending Accounting Pronouncements

Accounting Standards Adopted in 2011

In first quarter 2011, we adopted Accounting Standards Update (ASU) 2010-28 *When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts* and ASU 2010-29 *Disclosure of Supplementary Pro Forma Information for Business Combinations*. In fourth quarter 2011, we early adopted ASU 2011-08 *Testing Goodwill for Impairment*. Adoption of these pronouncements did not affect our earnings or financial position.

Pending Accounting Standards

Pending ASU 2011-04 *Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* and ASU 2011-05 *Comprehensive Income: Presentation of Comprehensive Income* will be effective first quarter 2012. Pending ASU 2011-10 *Property, Plant, and Equipment: Derecognition of in Substance Real Estate* will be effective first quarter 2013. Adoptions of these ASUs are not anticipated to have a significant effect on our earnings or financial position but may result in certain additional disclosures.

Note 3 2009 Strategic Initiatives and Assets Held for Sale

In 2009, we announced our strategic initiatives to enhance shareholder value by: generating significant cash flow, principally from the sale of 175,000 acres of higher and better use timberland; reducing debt by $150,000,000; and repurchasing up to 20 percent of our common stock.

In 2011, we sold 57,000 acres of timberland in Georgia, Alabama, and Texas for $87,061,000 in two transactions generating combined net proceeds of $86,018,000, which were principally used to reduce debt, pay taxes and reinvest in our business. These transactions resulted in combined gains of $61,784,000. In addition, we repurchased about 907,000 shares of our common stock for $12,977,000, which are classified as treasury stock.

We have completed our strategic initiatives related to the sale of higher and better use timberland and reduction of debt. Since announcing these initiatives, we have sold 176,000 acres of timberland in Georgia, Alabama and Texas for $284,442,000 in 11 transactions. These transactions generated net proceeds of $277,909,000 and resulted in gains of $194,438,000. We used the proceeds principally to reduce debt, pay income taxes, reinvest in our business and repurchase our common stock. At year-end 2011, our total debt was reduced by $154,096,000 since first quarter-end 2009, excluding $26,500,000 in non-recourse borrowings secured by a 401 unit multifamily property we acquired in fourth quarter 2010. In addition, we have repurchased about 1,908,000 shares of our common stock for $28,155,000 since announcing these initiatives.

Note 4 Goodwill and Other Intangible Assets

Carrying value of goodwill and other intangible assets follows:

	At Year-End	
	2011	2010
	(In thousands)	
Goodwill	$ 3,874	$ 3,874
Identified intangibles, net	1,577	2,653
	$ 5,451	$ 6,527

Goodwill represents the excess of the purchase price over the fair value of the tangible and identifiable intangible assets associated with the acquisition of a water resources company in 2010.

Table of Contents

Identified intangibles include indefinite lived groundwater leases associated with a water resources company acquired in fourth quarter 2010 of $1,577,000, and $1,076,000 related to the fair value of existing leases in place associated with a 401 unit multifamily property in Houston, Texas, also acquired in fourth quarter 2010. In 2011, we fully amortized the value assigned to the existing leases in place at the time of acquisition related to the multifamily property which is included in other operating expenses.

Note 5 Real Estate

Real estate consists of:

	At Year-End	
	2011	2010
	(In thousands)	
Entitled, developed and under development projects	$ 383,026	$ 402,519
Undeveloped land	80,076	86,608
Income producing properties		
Carrying value	129,220	95,963
Accumulated depreciation	(26,955)	(23,438)
Net carrying value	102,265	72,525
	$ 565,367	$ 561,652

Included in entitled, developed and under development projects are the estimated costs of assets we expect to convey to utility and improvement districts of $61,526,000 in 2011 and $58,941,000 in 2010, including about $34,802,000 at year-end 2011 and about $36,552,000 at year-end 2010 related to our Cibolo Canyons project near San Antonio. These costs relate to water, sewer and other infrastructure assets we have submitted to utility or improvement districts for approval and reimbursement. We submitted for reimbursement to these districts $3,328,000 in 2011 and $3,316,000 in 2010. We collected $3,294,000 from these districts in 2011, of which $1,750,000 related to our Cibolo Canyons project and was accounted for as a reduction of our investment in the mixed-use development. We collected $4,752,000 from these districts in 2010, of which $500,000 related to our Cibolo Canyons project and was accounted for as a reduction of our investment in the mixed-use development. We expect to collect the remaining amounts billed when these districts achieve adequate tax bases to support payment.

Also included in entitled, developed and under development projects is our investment in the resort development owned by third parties at our Cibolo Canyons project. In 2011 and 2010, we received $6,906,000 and $1,000,000 from the Special Improvement District (SID) from hotel occupancy and sales revenues collected as taxes by the SID. We currently account for these receipts as a reduction of our investment in the resort development. At year-end 2011, we have $35,368,000 invested in the resort development.

At year-end 2011, income producing properties primarily represents our investment in a 401 unit multifamily property in Houston with net carrying value of $46,659,000 and a 413 guest room hotel in Austin with net carrying value of $21,196,000. In addition, in 2011, we reclassified $4,550,000 in land from entitled, developed and under development projects to income producing properties as result of commencing construction on a 289 unit multifamily project in Austin, Texas. At year-end 2011, our investment in this project including land and construction in progress is $13,428,000 with an estimated cost to complete construction of $17,108,000. In addition, we acquired three multifamily development sites located in Austin, Denver and Dallas for $15,981,000.

We recognized non-cash asset impairment charges $11,525,000 in 2011 principally associated with owned and consolidated residential real estate projects located near Denver and the Texas gulf coast. We recognized non-cash asset impairment charges of $9,042,000 in 2010 principally associated with a residential development project located near Atlanta and a residential development with golf course and country club property located near Fort Worth. We recognized non-cash asset impairment charges of $5,718,000 in 2009 principally related to a condominium project in Austin.

Table of Contents

Depreciation expense related to income producing properties, was $3,547,000 in 2011, $2,680,000 in 2010 and $1,873,000 in 2009 and is included in other operating expense. Depreciation expense increased in 2011 primarily as a result of our 2010 acquisition of a 401 unit multifamily property in Houston. Please read Schedule III for additional information.

Note 6 Timber

We own directly or through ventures about 131,000 acres of timber, primarily in Georgia, and about 17,000 acres of timber under lease. The non-cash cost of timber cut and sold was $990,000 in 2011, $1,544,000 in 2010 and $3,104,000 in 2009.

Note 7 Investment in Unconsolidated Ventures

At year-end 2011, we had ownership interests ranging from 25 to 50 percent in 10 ventures that we account for using the equity method. We have no real estate ventures that are accounted for using the cost method. Our three largest ventures at year-end 2011 are CL Realty, Temco and Palisades West. We own a 50 percent interest in both CL Realty and Temco, and Cousins Real Estate Corporation owns the other 50 percent interest. We own a 25 percent interest in Palisades West, Cousins Properties Incorporated owns a 50 percent interest and Dimensional Fund Advisors LP owns the remaining 25 percent. Information regarding these ventures follows:

CL Realty, L.L.C. was formed in 2002 for the purpose of developing residential and mixed-use communities in Texas and across the southeastern United States. At year-end 2011, the venture had 14 residential and mixed-use communities, of which 10 are in Texas, 3 are in Florida and 1 is in Georgia, representing about 4,640 planned residential lots and 378 commercial acres. Subsequent to year-end 2011, we entered into an agreement to acquire certain of the venture s real estate assets. Please read Note 23 for additional information.

Temco Associates, LLC was formed in 1991 for the purpose of acquiring and developing residential real estate sites in Georgia. At year-end 2011, the venture had 4 residential and mixed-use communities, representing about 1,507 planned residential lots, all of which are located in Paulding County, Georgia. The venture also owns approximately 5,800 acres of undeveloped land in Paulding County, Georgia. Subsequent to year-end 2011, we entered into an agreement to acquire certain of the venture s real estate assets. Please read Note 23 for additional information.

Palisades West LLC was formed in 2006 for the purpose of constructing a commercial office park in Austin, Texas. The project includes two office buildings totaling approximately 375,000 square feet and an accompanying parking garage. At year-end 2011, the buildings are approximately 99 percent leased. Effective fourth quarter 2008, we entered into a 10-year operating lease for approximately 32,000 square feet that we occupy as our corporate headquarters. Rents paid under this operating lease were $1,172,000 in 2011, $1,190,000 in 2010 and $1,123,000 in 2009 and are included in general and administrative and other operating expenses. Subsequent to year-end 2011, we sold our interest in this venture. Please read Note 23 for additional information.

Combined summarized balance sheet information for our ventures accounted for using the equity method follows:

	Year-End 2011					Year-End 2010				
	CL Realty	Temco	Palisades West	Other Ventures	Total	CL Realty	Temco	Palisades West	Other Ventures	Total
	(In thousands)									
Real estate	$ 50,050	$ 18,741	$ 119,017	$ 71,842	$ 259,650	$ 85,436	$ 60,454	$ 124,696	$ 74,618	$ 345,204
Total assets	51,096	18,922	124,588	75,060	269,666	86,657	60,610	129,378	78,059	354,704
Borrowings[a]	1,056	2,787		70,975	74,818	2,663	2,929		74,606	80,198
Total liabilities	2,488	3,026	42,953[b]	85,704	134,171	4,123	3,134	48,612[b]	87,145	143,014
Equity	48,608	15,896	81,635	(10,644)	135,495	82,534	57,476	80,766	(9,086)	211,690
Our investment in real estate ventures:										
Our share of their equity[c]	24,304	7,948	20,412	12,495	65,159	41,267	28,738	20,191	14,075	104,271
Unrecognized deferred gain[d]				(936)	(936)	(2,190)			(915)	(3,105)
Investment in real estate ventures	$ 24,304	$ 7,948	$ 20,412	$ 11,559	$ 64,223	$ 39,077	$ 28,738	$ 20,191	$ 13,160	$ 101,166

Table of Contents

Combined summarized income statement information for our ventures accounted for using the equity method follows:

	For the Year		
	2011	**2010**	**2009**
		(In thousands)	
Revenues:			
CL Realty	$ 9,141	$ 28,663	$ 2,760
Temco	653	2,180	1,420
Palisades West	16,230	13,588	12,496
Other ventures	14,850	12,074	7,659
Total	$ 40,874	$ 56,505	$ 24,335
Earnings (loss):			
CL Realty[e]	$ (22,832)	$ 228	$ (8,500)
Temco[f]	(42,242)	210	(2,728)
Palisades West	5,858	4,668	4,626
Other ventures[g]	(195)	(17,421)	(2,629)
Total	$ (59,411)	$ (12,315)	$ (9,231)
Our equity in their earnings (loss):			
CL Realty	$ (11,416)	$ 114	$ (4,250)
Temco	(21,121)	105	(1,364)
Palisades West	1,464	1,167	1,156
Other ventures[c]	(360)	(1,554)	(3,313)
Recognition of deferred gain[d]	2,224	4,869	
Total	$ (29,209)	$ 4,701	$ (7,771)

(a) Total includes current maturities of $71,816,000 at year-end 2011, of which $43,144,000 is non-recourse to us and $75,121,000 at year-end 2010, of which $43,166,000 is non-recourse to us.

(b) Principally includes deferred income from leasehold improvements funded by tenants in excess of leasehold improvement allowances. These amounts are recognized as rental income over the lease term and are offset by depreciation expense related to these tenant improvements. There is no effect on venture net income.

(c) Our share of the equity in other ventures reflects our ownership interests ranging from 25 to 50 percent, excluding venture losses that exceed our investment where we are not obligated to fund those losses.

(d) Represents deferred gains on real estate contributed by us to ventures. We recognize the gains as real estate is sold to third parties. The deferred gains are reflected as a reduction to our investment in unconsolidated ventures. As a result of entering into an agreement to acquire certain of the venture s real estate assets, in 2011, we offset the remaining $2,164,000 in deferred gains related to CL Realty against our share of the venture s 2011 loss. Please read Note 23 for additional information. In 2010, we recognized about $4,869,000 in gains previously deferred by us as CL Realty sold about 625 acres in 2010 to a third party for $20,250,000.

(e) In 2011, CL Realty s loss includes non-cash impairment charges of $25,750,000, of which, $23,255,000 relates to additional non-cash impairments associated with real estate assets to be sold in 2012. Please read Note 23 for additional information. In 2010, CL Realty s earnings include impairment charges of $4,458,000 principally related to a commercial real estate project located near the Texas gulf coast. In 2009, CL Realty s loss includes impairment charges of $3,300,000 related to two residential real estate projects located in Tampa, Florida and an impairment charge of $5,238,000 related to an equity investment in an unconsolidated venture.

(f) In 2011, Temco s loss includes non-cash impairment charges of $41,226,000, of which, $21,426,000 principally relates to additional non-cash impairments associated with real estate assets to be sold in 2012. Please read Note 23 for additional information. In 2009, Temco Associates loss includes an impairment charge of $1,263,000 related to a residential real estate project located in Atlanta, Georgia.

(g) In 2010, other ventures loss includes a $13,061,000 loss on sale of a golf course and country club property in Denton, Texas. This loss did not impact our equity in the earnings (loss) of this venture as we exclude losses that exceed our investment where we are not obligated to provide additional equity.

In 2011, we invested $2,007,000 in these ventures and received $9,664,000 in distributions; in 2010, we invested $3,291,000 in these ventures and received $16,458,000 in distributions; and in 2009, we invested $2,875,000 in these ventures and received $4,056,000 in distributions. Distributions include both return of investments and distributions of earnings.

At year-end 2011, we participate in three partnerships that have total assets of $49,799,000 and total liabilities of $79,623,000, which includes $63,353,000 of borrowings classified as current maturities. These partnerships are managed by third parties who intend to extend or refinance these borrowings; however, there is no assurance that this can be done. Although these borrowings are guaranteed by third parties, we may under certain circumstances elect or be required to provide additional equity to these partnerships. We do not believe that the ultimate resolution of these matters will have a significant effect on our earnings or financial position. Our investment in these partnerships is $2,108,000 at year-end 2011. These three partnerships are variable interest entities. Please read Note 18 for additional information.

We provide development services for some of these ventures for which we receive fees. Fees for these services were $912,000 in 2011, $1,091,000 in 2010 and $45,000 in 2009 and are included in real estate and mineral revenues. In 2010, we received fees of $1,013,000 related to the sale of approximately 625 acres by CL Realty for marketing the property and closing the transaction on behalf of the venture.

Note 8 Receivables

Receivables consist of:

	At Year-End	
	2011	2010
	(In thousands)	
Non-performing loan	$ 20,666	$
Notes receivable, average interest rate of 7.16% at year-end 2011 and 7.93% at year-end 2010	1,817	1,057
Due from qualified intermediary		1,347
Receivables and accrued interest	860	1,155
	23,343	3,559
Allowance for bad debts	(62)	(144)
	$ 23,281	$ 3,415

In 2011, we acquired a non-performing loan from a financial institution for $21,137,000. The original loan commitment was $38,000,000 and the outstanding balance is about $34,791,000. The loan matured in February 2010. The note is secured by a lien on approximately 900 acres of developed and undeveloped real estate located near Houston, Texas designated for single-family residential and commercial development. We are not currently accruing interest and have not recorded any accretable yield due to the non-performing status of the loan. We cannot estimate the anticipated future cash flows because the borrower is in bankruptcy. In 2011, we received $471,000 in payments and accounted for these receipts as a reduction of the carrying value of the non-performing loan.

Notes receivable generally are secured by a deed of trust and generally due within three years.

Receivables and accrued interest principally include miscellaneous operating receivables arising in the normal course of business.

Table of Contents

Note 9 Debt

Debt consists of:

	At Year-End	
	2011	2010
	(In thousands)	
Senior secured credit facility		
Term loan facility average interest rate of 6.50% at year-end 2011 and year-end 2010	$ 130,000	$ 125,000
Revolving line of credit		
Secured promissory notes average interest rates of 4.34% at year-end 2011 and 4.51% at year-end 2010	41,900	41,716
Other indebtedness due through 2017 at variable and fixed interest rates ranging from 5.00% to 8.00%	49,687	54,873
	$ 221,587	$ 221,589

Our debt agreements contain financial covenants customary for such agreements including minimum levels of interest coverage and limitations on leverage. At year-end 2011, we were in compliance with the financial covenants of these agreements.

In 2011, we supplemented and amended our senior secured credit facility to provide us with, among other matters, additional flexibility with respect to the borrowing base, collateral coverage and leverage requirements. As a result, we increased our unused borrowing capacity and extended the maturity of our revolving line of credit by one year.

At year-end 2011, our senior secured credit facility provides for a $130,000,000 term loan maturing August 6, 2015 and a $200,000,000 revolving line of credit maturing August 6, 2014. The term loan and the revolving line of credit may be prepaid at any time without penalty. The revolving line of credit includes a $100,000,000 sublimit for letters of credit, of which $2,318,000 is outstanding at year-end 2011. Total borrowings under our senior secured credit facility (including the face amount of letters of credit) may not exceed a borrowing base formula. At year-end 2011, we had $156,128,000 in net unused borrowing capacity under our senior credit facility.

At our option, we can borrow at LIBOR plus 4.5 percent (subject to a 2 percent LIBOR floor) or prime plus 2.5 percent. Borrowings under the senior secured credit facility are secured by (a) all timberland, land in entitlement process, minerals and certain raw entitled land, (b) assignments of current and future leases, rents and contracts, including our mineral leases, (c) a security interest in our primary operating account, (d) pledge of the equity interests in current and future material operating subsidiaries or joint venture interests, or if such pledge is not permitted, a pledge of the right to distributions from such entities, to the extent permitted, and (e) negative pledge (without a mortgage) on all other wholly-owned assets. The senior secured credit facility provides for releases of real estate provided that borrowing base compliance is maintained.

At year-end 2011, secured promissory notes include a $26,500,000 non-recourse loan collateralized by a 401 unit multifamily project located in Houston with a carrying value of $46,659,000. This secured promissory note includes a prepayment penalty for payments prior to July 1, 2017 and no prepayment penalty thereafter. The prepayment penalty is based on the difference between the fixed annual note rate of 4.94 percent and the assumed reinvestment rate based on the five year treasury constant maturity rate. In addition, in third quarter 2011, we borrowed $15,400,000 which is secured by a 413 guest room hotel located in Austin with a carrying value of $21,196,000. This financing replaced debt retired in second quarter 2011.

At year-end 2011, other indebtedness, principally non-recourse, is collateralized by entitled, developed and under development projects with a carrying value of $111,729,000. Please read Schedule III for additional information.

At year-end 2011, we have $8,364,000 in unamortized deferred fees which are included in other assets. Amortization of deferred financing fees was $2,881,000 in 2011, $4,106,000 in 2010 and $5,205,000 in 2009 and is included in interest expense.

Table of Contents

In 2010, other indebtedness decreased by $13,207,000 due to lender foreclosure of a lien on a condominium property in Austin, Texas owned by a consolidated variable interest entity. Please read Note 18 for additional information.

Debt maturities during the next five years are: 2012 $4,953,000; 2013 $8,249,000; 2014 $47,068,000; 2015 $131,275,000; 2016 $2,125,000 and thereafter $27,917,000.

Note 10 Fair Value

Non-financial assets measured at fair value on a non-recurring basis principally include real estate assets, assets held for sale, goodwill and intangible assets, which are measured for impairment. In 2011 and 2010, certain real estate assets were remeasured and reported at fair value due to events or circumstances that indicated the carrying value may not be recoverable. We determined estimated fair value based on the present value of future probability weighted cash flows expected from the sale of the long-lived asset or based on a third-party appraisal of current value. As a result, we recognized non-cash asset impairments of $11,525,000 in 2011 and $9,042,000 in 2010 associated with our owned and consolidated projects. The carrying value of these assets may have subsequently increased or decreased from the fair value reflected due to activity that has occurred since the measurement date.

	Year-End 2011				Year-End 2010			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
				(In thousands)				
Non-Financial Assets and Liabilities:								
Real estate	$	$	$ 24,161	$ 24,161	$	$	$ 10,386	$ 10,386

We elected not to use the fair value option for cash and cash equivalents, accounts receivable, other current assets, variable debt, accounts payable and other current liabilities. The carrying amounts of these financial instruments approximate their fair values due to their short-term nature or variable interest rates. We determine the fair value of fixed rate financial instruments using quoted prices for similar instruments in active markets.

Information about our fixed rate financial instruments not measured at fair value follows:

	Year-End 2011		Year-End 2010		
	Carrying Amount	Fair Value	Carrying Amount	Fair Value	Valuation Technique
			(In thousands)		
Fixed rate debt	$ (29,931)	$ (32,478)	$ (29,931)	$ (30,164)	Level 2

Note 11 Capital Stock

Pursuant to our shareholder rights plan, each share of common stock outstanding is coupled with one-quarter of a preferred stock purchase right (Right). Each Right entitles our shareholders to purchase, under certain conditions, one one-hundredth of a share of newly issued Series A Junior Participating Preferred Stock at an exercise price of $100. Rights will be exercisable only if someone acquires beneficial ownership of 20 percent or more of our common shares or commences a tender or exchange offer, upon consummation of which they would beneficially own 20 percent or more of our common shares. We will generally be entitled to redeem the Rights at $0.001 per Right at any time until the 10th business day following public announcement that a 20 percent position has been acquired. The Rights will expire on December 11, 2017.

Please read Note 19 Share-Based Compensation for information about additional shares of common stock that could be issued under terms of our share-based compensation plans.

As a result of the 2007 spin-offs from Temple-Inland, at year-end 2011, personnel of Temple-Inland and the other spin-off entity held 18,000 awards that will be settled in shares of our common stock and options to purchase 1,107,000 shares of our common stock. The options, all of which are exercisable, have a weighted average exercise price of $21.61 and a weighted average remaining contractual term of three years. At year-end 2011, the options have an aggregate intrinsic value of $922,000.

75

Table of Contents

Note 12 Other Comprehensive Income

Other comprehensive income consists of:

	2011	For the Year 2010 (In thousands)	2009
Consolidated net income	$ 9,241	$ 5,834	$ 61,574
Change in fair value of interest rate swap agreement (matured in 2010)		393	1,546
Income tax effect of change in fair value		(137)	(542)
Other comprehensive income	9,241	6,090	62,578
Less: Comprehensive income attributable to noncontrolling interests	(2,087)	(709)	(2,467)
Other comprehensive income attributable to Forestar Group Inc.	$ 7,154	$ 5,381	$ 60,111

Note 13 Net Income per Share

Earnings available to common shareholders and weighted average common shares outstanding used to compute earnings per share were:

	2011	For the Year 2010 (In thousands)	2009
Earnings available to common shareholders:			
Consolidated net income	$ 9,241	$ 5,834	$ 61,574
Less: Net income attributable to noncontrolling interest	(2,087)	(709)	(2,467)
Net income attributable to Forestar Group Inc.	$ 7,154	$ 5,125	$ 59,107
Weighted average common shares outstanding basic	35,413	35,893	35,890
Dilutive effect of stock options	142	196	94
Dilutive effect of restricted stock and restricted stock units	226	288	118
Weighted average common shares outstanding diluted	35,781	36,377	36,102
Anti-dilutive awards excluded from diluted weighted average shares outstanding	2,008	1,574	1,812

Note 14 Income Taxes

Income tax expense consists of:

	2011	For the Year 2010 (In thousands)	2009
Current tax provision:			
U.S. Federal	$ (27,442)	$ (7,582)	$ (51,210)
State and other	(3,013)	(1,252)	(7,031)
	(30,455)	(8,834)	(58,241)
Deferred tax provision:			
U.S. Federal	26,264	6,084	21,639
State and other	1,170	280	969

	27,434	6,364	22,608
Income tax expense	$ (3,021)	$ (2,470)	$ (35,633)

Our income tax expense reflects a benefit of $901,000 in 2009 from a federal income tax rate change for qualified timber gains pursuant to the Food, Conservation and Energy Act of 2008.

Table of Contents

A reconciliation of the federal statutory rate to the effective income tax rate on continuing operations follows:

	For the Year		
	2011	2010	2009
Federal statutory rate	35 %	35 %	35 %
State, net of federal benefit	10	8	4
Noncontrolling interests	(6)	(3)	(1)
Charitable contributions	(6)	(5)	
Compensation		3	
Percentage depletion	(8)	(10)	
Qualified timber gains			(1)
Other		2	
Effective tax rate	25 %	30 %	37 %

Significant components of deferred taxes are:

	At Year-End	
	2011	2010
	(In thousands)	
Deferred Tax Assets:		
Real estate	$ 74,970	$ 57,419
Employee benefits	11,284	10,686
Accruals not deductible until paid	1,113	1,013
Gross deferred tax assets	87,367	69,118
Deferred Tax Liabilities:		
Undeveloped land	(8,479)	(14,174)
Income producing properties	(4,093)	(5,069)
Timber	(1,853)	(2,734)
Gross deferred tax liabilities	(14,425)	(21,977)
Net Deferred Tax Asset	$ 72,942	$ 47,141

In 2010, deferred tax liabilities associated with income producing properties increased principally due to the deferral under IRC Section 1031 of about $20,700,000 in gains from the sale of timber and timberland. We used $23,045,000 of the proceeds held by a qualified intermediary and $26,500,000 of non-recourse borrowings to fund the acquisition of a 401 unit, Class A multifamily property. These transactions resulted in a deferred tax liability of $7,448,000.

We file income tax returns in the U.S. federal jurisdiction and in various state jurisdictions. In 2011, the Internal Revenue Service (IRS) completed its examination of our 2008 and 2007 (one day of operations) federal income tax returns. No changes were made to these returns as a result of the examination.

Prior to our spin-off, we were included in Temple-Inland s consolidated income tax returns. In conjunction with our spin-off, we entered into an agreement with Temple-Inland whereby we agreed to indemnify Temple-Inland for any adjustments related to our tax positions reported in their pre-spin income tax returns. With few exceptions, we are no longer subject to U.S. federal or state income tax examinations by tax authorities for years prior to 2006. In 2009, Temple-Inland informed us that the IRS began an examination of its 2007 and 2006 federal income tax returns. This examination is still in process as of year-end 2011 but we were informed that the IRS has not proposed any adjustments affecting our reported tax positions.

Table of Contents

A reconciliation of the beginning and ending amount of tax benefits not recognized for book purposes is as follows:

	At Year-End		
	2011	2010	2009
	(In thousands)		
Balance at beginning of year	$ 7,394	$ 7,441	$
Additions based on tax positions related to the current year			7,441
Additions for tax positions of prior years			
Reductions for tax positions of prior years	(1,563)	(47)	
Settlements			
Balance at end of year	$ 5,831	$ 7,394	$ 7,441

At year-end 2011, 2010 and 2009, there were $5,831,000, $6,019,000 and 6,066,000 of tax benefits not recognized for book purposes that would affect the annual effective tax rate, if recognized.

We recognize interest accrued related to unrecognized tax benefits in income tax expense. In 2011, 2010 and 2009, we recognized approximately $41,000, $133,000 and $96,000 in interest. At year-end 2011, 2010 and 2009, we have $269,000, $229,000 and $96,000 of accrued interest and no penalties.

Note 15 Litigation and Environmental Contingencies

We are involved in various legal proceedings that arise from time to time in the ordinary course of doing business and believe that adequate reserves have been established for any probable losses. We do not believe that the outcome of any of these proceedings should have a significant adverse effect on our financial position, long-term results of operations or cash flows. It is possible, however, that charges related to these matters could be significant to our results or cash flows in any one accounting period.

Environmental remediation liabilities arise from time to time in the ordinary course of doing business, and we believe we have established adequate reserves for any probable losses that we can reasonably estimate. We own 288 acres near Antioch, California, portions of which were sites of a former Temple-Inland paper manufacturing operation that are in remediation. We have received certificates of completion on all but 80 acres, a portion of which includes subsurface contamination. In 2011, we increased our reserves for environmental remediation by $2,500,000 due to additional testing and remediation requirements by the state regulatory agencies. We estimate the cost to complete remediation activities will be approximately $2,451,000, which is included in other accrued expenses. It is possible that remediation or monitoring activities could be required in addition to those included within our estimate, but we are unable to determine the scope, timing or extent of such activities.

Note 16 Commitments and Other Contingencies

We lease timberland, facilities and equipment under non-cancelable long-term operating lease agreements. In addition, we have various obligations under other office space and equipment leases of less than one year. Lease expense on timberland was $349,000 in 2011, $289,000 in 2010 and $366,000 in 2009. Rent expense on facilities and equipment was $2,000,000 in 2011, $2,048,000 in 2010 and $1,982,000 in 2009. Future minimum rental commitments under non-cancelable operating leases having a remaining term in excess of one year are: 2012 $2,531,000; 2013 $2,424,000; 2014 $2,114,000; 2015 $2,072,000; 2016 $1,851,000 and thereafter $10,718,000.

We have 14 years remaining on a 65-year timber lease of over 16,000 acres. At year-end 2011, the remaining contractual obligation for this lease is $10,224,000.

In 2008, we entered into a 10-year operating lease for approximately 32,000 square feet in Austin, Texas, which we occupy as our corporate headquarters. This lease contains predetermined fixed increases of the minimum rental rate during the initial lease term and a construction allowance for leasehold improvements. The remaining contractual obligation for this lease is $8,839,000.

In connection with our unconsolidated venture operations, we have provided performance bonds and letters of credit aggregating $1,428,000 at year-end 2011. Generally these performance bonds and letters of credit would be drawn on due to lack of specific performance by the ventures, such as failure to deliver streets and utilities in accordance with local codes and ordinances.

Table of Contents

Temple-Inland has received a private letter ruling from the Internal Revenue Service that our 2007 spin-off qualifies for tax-free treatment under applicable sections of the Internal Revenue Code, and has also received an opinion of tax counsel that the spin-off so qualifies. However, if the spin-off fails to qualify for tax-free treatment, under the tax matters agreement between Temple-Inland and us we may be required to indemnify Temple-Inland against any tax resulting from the distribution of our shares of stock to the extent that such tax resulted from any of our representations or undertakings being incorrect or violated.

Note 17 Segment Information

We manage our operations through three business segments: real estate, mineral resources and fiber resources. Real estate secures entitlements and develops infrastructure on our lands for single-family residential and mixed-use communities, and manages our undeveloped land and income producing properties, primarily a hotel and a multifamily property. Mineral resources manages our oil, natural gas and water interests. Fiber resources manages our timber and recreational leases.

We evaluate performance based on segment earnings (loss) before unallocated items and income taxes. Segment earnings (loss) consist of operating income, equity in earnings (loss) of unconsolidated ventures and net (income) loss attributable to noncontrolling interests. Items not allocated to our business segments consist of general and administrative expense, share-based compensation, gain on sale of assets, interest expense and other non-operating income and expense. The accounting policies of the segments are the same as those described in the accounting policy note to the consolidated financial statements. Our revenues are derived from our U.S. operations and all of our assets are located in the U.S. In 2011, revenues of $17,980,000 from one customer of our real estate segment exceeded 10 percent of our total revenues as result of selling about 9,700 acres of undeveloped land from our retail sales program.

	Real Estate	Mineral Resources	Fiber Resources	Items Not Allocated to Segments	Total
			(In thousands)		
For the year or at year-end 2011:					
Revenues	$ 106,168	$ 24,584	$ 4,821	$	$ 135,573
Depreciation, depletion and amortization	5,729	339	39	3,705	9,812
Equity in earnings (loss) of unconsolidated ventures	(30,626)	1,394	23		(29,209)
Income (loss) before taxes	(25,704)	16,023	1,893	17,963[(a)]	10,175
Total assets	659,802	16,199	14,444	104,412	794,857
Investment in unconsolidated ventures	64,223				64,223
Capital expenditures [(b)]	739	4,796	47	766	6,348
For the year or at year-end 2010:					
Revenues	$ 68,269	$ 24,790	$ 8,301	$	$ 101,360
Depreciation, depletion and amortization	3,089	333	39	5,553	9,014
Equity in earnings of unconsolidated ventures	2,629	2,072			4,701
Income (loss) before taxes	(4,634)	22,783	5,058	(15,612)[(a)]	7,595
Total assets	668,689	13,399	18,258	88,978	789,324
Investment in unconsolidated ventures	101,166				101,166
Capital expenditures [(b)]	2,392	49	3	258	2,702
For the year or at year-end 2009:					
Revenues	$ 94,436	$ 36,256	$ 15,559	$	$ 146,251
Depreciation, depletion and amortization	2,167	253	35	7,331	9,786
Equity in earnings (loss) of unconsolidated ventures	(8,161)	390			(7,771)
Income before taxes	3,182	32,370	9,622	49,566[(a)]	94,740
Total assets	654,250	1,356	20,088	109,040	784,734
Investment in unconsolidated ventures	109,597				109,597
Capital expenditures [(b)]	5,368	1,284	120	523	7,295

79

[a] Items not allocated to segments consist of:

	For the Year		
	2011	2010	2009
	(In thousands)		
General and administrative expense	$ (20,110)	$ (17,341)	$ (22,399)
Share-based compensation expense	(7,067)	(11,596)	(11,998)
Gain on sale of assets	61,784	28,607	104,047
Interest expense	(17,012)	(16,446)	(20,459)
Other non-operating income	368	1,164	375
	$ 17,963	$ (15,612)	$ 49,566

[b] Consists of expenditures for property and equipment and reforestation.

In 2011, general and administrative expense includes $3,187,000 associated with proposed private debt offerings that we withdrew as a result of deterioration of terms available to us in the credit markets. Share-based compensation decreased principally as a result of a decline in our stock price and its impact on cash-settled awards. Gain on sale of assets represents the sale of about 57,000 acres of timberland in Georgia, Alabama and Texas for $87,061,000 in accordance with our 2009 strategic initiatives, which we completed in 2011.

In 2010, gain on sale of assets represents the sale of over 24,000 acres of timberland in Georgia, Alabama and Texas for $38,778,000 in accordance with our 2009 strategic initiatives. Interest expense decreased principally due to lower interest rates as a result of the maturity of our interest rate swap agreement and decreased amortization of prepaid loan fees.

In 2009, general and administrative expenses include about $3,200,000 paid to outside advisors regarding an evaluation by our Board of Directors of an unsolicited shareholder proposal and a $2,213,000 impairment charge related to our undivided 15 percent interest in corporate aircraft contributed to us by Temple-Inland at spin-off.

In 2009, gain on sale of assets represents the sale of about 95,000 acres of timber and timberland in Georgia and Alabama for $158,603,000 in accordance with our 2009 strategic initiatives.

Note 18 Variable Interest Entities

We participate in real estate ventures for the purpose of acquiring and developing residential and mixed-use communities in which we may or may not have a controlling financial interest. Generally accepted accounting principles require consolidation of variable interest entities (VIE) in which an enterprise has a controlling financial interest and is the primary beneficiary. A controlling financial interest will have both of the following characteristics: (a) the power to direct the VIE activities that most significantly impact economic performance and (b) the obligation to absorb the VIE losses and right to receive benefits that are significant to the VIE. We examine specific criteria and use judgment when determining whether we are the primary beneficiary and must consolidate a VIE. We perform this review initially at the time we enter into venture agreements and subsequently when reconsideration events occur.

At year-end 2011, we are the primary beneficiary of two VIEs that we consolidate. We have provided the majority of equity to these VIEs, which absent our contributions or advances do not have sufficient equity to fund their operations. We have the authority to approve project budgets and the issuance of additional debt. At year-end 2011, our consolidated balance sheet includes $15,109,000 in assets, principally real estate, and $2,893,000 in liabilities, principally debt, related to these two VIEs. In 2011, we contributed or advanced $3,252,000 to these VIEs. In 2010, real estate assets decreased by $11,865,000, debt decreased by $13,207,000 and other liabilities increased by $1,342,000 due to lender foreclosure of a lien on property owned by one of these VIEs. In 2011, our earnings benefited from a $1,342,000 reallocation of a previously recognized loss related to foreclosure of a lien on property in the above VIE. Based on our access to new information, we determined this loss and related liability should be allocated from us to the noncontrolling financial interests as we believe the likelihood we will be subject to any potential lender liabilities is remote. In addition, in 2011, we were released from liability due to settled litigation related to this property and as

result, our earnings benefited from the reversal of $1,741,000 in liabilities.

Also at year-end 2011, we are not the primary beneficiary of three VIEs that we account for using the equity method. The unrelated managing partners oversee the day-to-day operations and guarantee some of the debt of the VIEs while we have the authority to approve project budgets and the issuance of additional debt. Although some of the debt is guaranteed by the managing partners, we may under certain circumstances elect or be required to provide additional funds to these VIEs. At year-end 2011, these three VIEs have total assets of $49,799,000, substantially all of which represent developed and undeveloped real estate and total liabilities of $79,623,000, which includes $63,353,000 of borrowings classified as current maturities. These amounts are included in other ventures in the combined summarized balance sheet information for ventures accounted for using the equity method in Note 7. At year-end 2011, our investment in these three VIEs is $2,108,000 and is included in investment in unconsolidated ventures. In 2011, we contributed or advanced $188,000 to these VIEs. Our maximum exposure to loss related to these VIEs is estimated at $35,616,000, which exceeds our investment as we have a nominal general partner interest in two of these VIEs and could be held responsible for their liabilities. The maximum exposure to loss represents the maximum loss that we could be required to recognize assuming all the ventures assets (principally real estate) are worthless, without consideration of the probability of a loss or of any actions we may take to mitigate any such loss.

Note 19 Share-Based Compensation

Share-based compensation expense consists of:

	For the Year		
	2011	**2010**	**2009**
	(In thousands)		
Cash-settled awards	$ 1,095	$ 6,023	$ 8,174
Equity-settled awards	941		
Restricted stock	2,505	3,461	1,741
Stock options	2,526	2,112	2,083
	$ 7,067	$ 11,596	$ 11,998

Share-based compensation expense is included in:

	For the Year		
	2011	**2010**	**2009**
	(In thousands)		
General and administrative	$ 3,216	$ 5,240	$ 7,527
Other operating	3,851	6,356	4,471
	$ 7,067	$ 11,596	$ 11,998

In 2011, share-based compensation decreased as a result of a decline in our stock price and its impact on cash-settled awards.

The fair value of awards granted to retirement-eligible employees and expensed at the date of grant was $654,000 in 2011, $286,000 in 2010 and $183,000 in 2009. Unrecognized share-based compensation expense related to non-vested equity-settled awards, restricted stock and stock options is $7,363,000 at year-end 2011. The weighted average period over which this amount will be recognized is estimated to be two years. We did not capitalize any share-based compensation in 2011, 2010 or 2009.

In 2011 and 2010, we withheld 87,357 and 3,247 shares having a value of $1,547,000 and $61,000 in connection with vesting of restricted stock awards and exercises of stock options. These shares are accounted for as treasury stock and are reflected in financing activities in our consolidated statements of cash flows.

A summary of awards granted under our 2007 Stock Incentive Plan follows:

Cash-settled awards

Cash-settled awards granted to our employees in the form of restricted stock units or stock appreciation rights generally vest over three to four years from the date of grant and generally provide for accelerated vesting upon death, disability or if there is a change in control. Vesting for some restricted stock unit awards is also conditioned upon achievement of a minimum one percent annualized return on assets over a three-year period.

Table of Contents

Cash-settled stock appreciation rights have a ten-year term, generally become exercisable ratably over four years and provide for accelerated or continued vesting upon retirement, death, disability or if there is a change in control. Stock appreciation rights were granted with an exercise price equal to the market value of our stock on the date of grant.

Cash-settled awards granted to our directors in the form of restricted stock units are fully vested at the time of grant and payable upon retirement.

The following table summarizes the activity of cash-settled restricted stock unit awards in 2011:

	Equivalent Units (In thousands)	Weighted Average Grant Date Fair Value (Per unit)
Non-vested at beginning of period	376	$11.88
Granted	171	17.89
Vested	(88)	17.20
Forfeited	(10)	11.55
Non-vested at end of period	449	$13.13

The weighted average grant date fair value of our non-vested cash-settled restricted stock unit awards at year-end 2010 was $11.88 for 376,000 equivalent units and at year-end 2009 was $9.43 for 268,000 equivalent units.

The following table summarizes the activity of cash-settled stock appreciation rights in 2011:

	Rights Outstanding (In thousands)	Weighted Average Exercise Price (Per share)	Weighted Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value (Current Value Less Exercise Price) (In thousands)
Balance at beginning of period	909	$11.28	8	$7,289
Granted				
Exercised	(14)	9.29		
Forfeited				
Balance at end of period	895	$11.31	7	$3,986
Exercisable at end of period	393	$10.49	7	$1,970

The weighted average exercise price of our cash-settled stock appreciation rights at year-end 2010 was $11.28 for 909,000 awards and at year-end 2009 was $9.29 for 736,000 awards.

The fair value of awards settled in cash was $197,000 in 2011, $751,000 in 2010 and $23,000 in 2009. At year-end 2011, the fair value of vested cash-settled awards is $15,034,000 and is included in other liabilities. The aggregate current value of non-vested awards is $8,802,000 at

year-end 2011 based on a year-end stock price of $15.13.

Table of Contents

Equity-settled awards

Equity-settled awards granted to our employees include restricted stock units (RSU), which vest over or after three years from the date of grant, and beginning first quarter 2011, market-leveraged stock units (MSU), which vest after three years. The following table summarizes the activity of equity-settled awards in 2011:

	Equivalent Units (In thousands)	Weighted Average Grant Date Fair Value (Per unit)
Non-vested at beginning of period		$
Granted	160	20.73
Vested		
Forfeited	(1)	18.59
Non-vested at end of period	159	$ 20.74

In 2011, we granted 124,700 MSU awards. These awards will be settled in common stock based upon our stock price performance over three years from the date of grant. The number of shares to be issued could range from a high of 187,050 shares if our stock price increases by 50 percent or more, to a low of 62,350 shares if our stock price decreases by 50 percent, or could be zero if our stock price decreases by more than 50 percent, the minimum threshold performance. MSU awards are valued using a Monte Carlo simulation pricing model, which includes expected stock price volatility and risk-free interest rate assumptions. Compensation expense is recognized regardless of achievement of performance conditions, provided the requisite service period is satisfied.

Unrecognized share-based compensation expense related to non-vested equity-settled awards is $2,215,000 at year-end 2011. The weighted average period over which this amount will be recognized is estimated to be two years.

Restricted stock

Restricted stock awards vest either ratably over or after three years, generally if we achieve a minimum one percent annualized return on assets over such three-year period. The following table summarizes the activity of restricted stock awards in 2011:

	Restricted Shares (In thousands)	Weighted Average Grant Date Fair Value (Per unit)
Non-vested at beginning of period	636	$ 17.56
Granted	40	13.89
Vested	(275)	20.71
Forfeited	(2)	17.80
Non-vested at end of period	399	$ 15.02

The weighted average grant date fair value of our non-vested restricted stock awards at year-end 2010 was $17.56 for 636,000 non-vested restricted shares and at year-end 2009 was $17.43 for 331,000 non-vested restricted shares.

Unrecognized share-based compensation expense related to non-vested restricted stock awards is $2,525,000 at year-end 2011. The weighted average period over which this amount will be recognized is estimated to be one year.

Stock options

Stock options have a ten-year term, generally become exercisable ratably over four years and provide for accelerated or continued vesting upon retirement, death, disability or if there is a change in control. Options were granted with an exercise price equal to the market value of our stock on the date of grant. The following table summarizes the activity of stock option awards in 2011:

	Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (Current Value Less Exercise Price)
	(In thousands)	(Per share)	(In years)	(In thousands)
Balance at beginning of period	957	$ 23.45	8	$ 1,890
Granted	327	18.59		
Exercised				
Forfeited				
Balance at end of period	1,284	$ 22.22	7	$ 944
Exercisable at end of period	646	$ 25.58	6	$ 472

We estimate the fair value of stock options using the Black-Scholes option pricing model and the following assumptions:

	For the Year		
	2011	2010	2009
Expected stock price volatility	56.2 %	51.0 %	41.8 %
Risk-free interest rate	2.4 %	2.3 %	1.8 %
Expected life of options (years)	6	6	6
Weighted average estimated fair value of options at grant date	$ 10.11	$ 8.98	$ 3.94

We have limited historical experience as a stand-alone company so we utilized alternative methods in determining our valuation assumptions. The expected life was based on the simplified method utilizing the midpoint between the vesting period and the contractual life of the awards. In 2011, the expected stock price volatility was based on a blended rate utilizing our historical volatility and historical prices of our peers common stock for a period corresponding to the expected life of the options. In 2010 and 2009, the expected stock price volatility was based on historical prices of our peers common stock for a period corresponding to the expected life of the options. Pre-vesting forfeitures are estimated based upon the pool of participants and their expected activity and historical trends.

Unrecognized share-based compensation expense related to non-vested stock options is $2,623,000 at year-end 2011. The weighted average period over which this amount will be recognized is estimated to be two years.

Pre-Spin Awards

Certain of our employees participated in Temple-Inland s share-based compensation plans. In conjunction with our 2007 spin-off, these awards were equitably adjusted into separate awards of the common stock of Temple-Inland and the spin-off entities.

Stock options have a ten-year term, generally become exercisable ratably over four years and provide for accelerated or continued vesting upon retirement, death, disability or if there is a change in control. A summary of stock option awards outstanding year-end 2011 follows:

	Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual	Aggregate Intrinsic Value (Current Value Less

	(In thousands)	(Per share)	Term (In years)	Exercise Price) (In thousands)
Outstanding and exercisable on Forestar stock	71	$ 22.86	4	$ 69
Outstanding and exercisable on Temple-Inland stock	102	$ 20.74	4	1,116
				$ 1,185

Table of Contents

The intrinsic value of options exercised was $766,000 in 2011, $578,000 in 2010 and $287,000 in 2009.

Note 20 Retirement Plans

Our defined contribution retirement plans include a 401(k) plan, which is funded, and a supplemental plan for certain employees, which is unfunded. The expense of our defined contribution retirement plans was $924,000 in 2011, $679,000 in 2010 and $717,000 in 2009. The unfunded liability for our supplemental plan was $369,000 at year-end 2011 and $305,000 at year-end 2010, and $205,000 at year-end 2009 and is included in other liabilities.

Note 21 Supplemental Oil and Natural Gas Disclosures (Unaudited)

The following unaudited information regarding our oil and natural gas reserves has been prepared and is presented pursuant to requirements of the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB).

We lease our mineral interests, principally in Texas and Louisiana, to third-party entities for the exploration and production of oil and natural gas. When we lease our mineral interests, we may negotiate a lease bonus payment and we retain a royalty interest and may take an additional participation in production, including a non-operating working interest in which we pay a share of the costs to drill, complete and operate a well and receive a proportionate share of the production revenues. We are also taking steps to become an operator with respect to oil and natural gas drilling and producing activities.

We engaged independent petroleum engineers, Netherland, Sewell & Associates, Inc., to prepare estimates of our proved developed oil and natural gas reserves, all of which are located in the U.S., and future net cash flows as of year-end 2011, 2010 and 2009. These estimates were based on the economic and operating conditions existing at year-end 2011, 2010 and 2009. Proved developed reserves are those quantities of petroleum from existing wells and facilities, which by analysis of geosciences and engineering data, can be estimated with reasonable certainty to be commercially recoverable, from a given date forward for known reservoirs and under defined economic conditions, operating methods and government regulations. This reserve information does not include estimates of reserves and future cash flows associated with proved undeveloped reserves or any potential value related to our over 563,000 undeveloped mineral acres because, at year-end 2011, we are solely royalty and minority non-operating working interest owners and as a result we do not determine whether or when undeveloped reserves will be converted to developed reserves.

In December 2009, we adopted revised oil and natural gas reserve estimation and disclosure requirements to conform to the SEC Modernization of Oil and Gas Reporting rules. The SEC rules require disclosure of proved reserves using the twelve-month average beginning-of-month price (which we refer to as the average price) for the year. These same average prices are also used in calculating the amount of (and changes in) future net cash inflows related to the standardized measure of discounted future net cash flows.

For 2011, 2010 and 2009, the average price per barrel of oil based on the West Texas Intermediate Crude price is $92.71, $75.96 and $57.65 and the average price per MMBTU of natural gas based on the Henry Hub spot market is $4.12, $4.38 and $3.87. All prices were adjusted for quality, transportation fees and regional price differentials.

The process of estimating proved reserves and future net cash flows is complex involving decisions and assumptions in evaluating the available engineering and geologic data and prices for oil and natural gas and the cost to produce these reserves and other factors, many of which are beyond our control. As a result, these estimates are imprecise and should be expected to change as future information becomes available. These changes could be significant. In addition, this information should not be construed as being the current fair market value of our proved developed reserves.

Table of Contents

Estimated Quantities of Proved Developed Oil and Natural Gas Reserves

Estimated quantities of proved developed oil and natural gas reserves are summarized as follows:

	Net Reserves	
	Oil (Barrels)	Natural Gas (Mcf)
	(In thousands)	
Consolidated entities:		
Year-end 2008	457	7,538
Revisions of previous estimates	171	(484)
Extensions and discoveries	59	1,018
Production	(107)	(1,412)
Year-end 2009	580	6,660
Revisions of previous estimates	123	709
Extensions and discoveries	21	514
Production	(115)	(1,224)
Year-end 2010	609	6,659
Revisions of previous estimates	197	3
Extensions and discoveries	410	2,670
Production	(152)	(1,129)
Year-end 2011	1,064	8,203
Our share of ventures accounted for using the equity method:		
Year-end 2008		125
Revisions of previous estimates		2
Extensions and discoveries		2,463
Production		(82)
Year-end 2009		2,508
Revisions of previous estimates		1,041
Extensions and discoveries		895
Production		(573)
Year-end 2010		3,871
Revisions of previous estimates		(95)
Extensions and discoveries		
Production		(493)
Year-end 2011		3,283
Total consolidated and our share of equity method ventures:		
Year-end 2009	580	9,168
Year-end 2010	609	10,530
Year-end 2011	1,064	11,486

We do not have any estimated reserves of synthetic oil, synthetic natural gas or products of other non-renewable natural resources that are intended to be upgraded into synthetic oil and natural gas.

In 2011, increases in oil prices accounted for about 28,000 barrels of the upward revisions in oil reserves for our consolidated entities. The remaining upward revisions to oil reserves were attributable to continued improved response from a steam injection program, improved operational efficiencies from water drive reservoirs, improved performance of recently completed oil wells and generally from improved production performances as a result of more efficient operations driven by higher oil prices.

In 2010, increases in oil and natural gas prices accounted for about 27,000 barrels and about 475,000 Mcf of upward revisions in reserves for our consolidated entities. The remaining upward revisions to oil reserves were attributable to improved performance of natural water drive reservoirs, response from a lease steam injection program, a work-over and installation of gas lift valves on a high volume and high royalty

interest well, improved performance from a well that came online in late 2009 and the associated natural gas liquids,

reactivation of two abandoned oil wells, two recompletions, and generally from improved production performances as a result of more efficient operations driven by higher oil prices. The balance of the upward revisions to natural gas reserves is attributable to the associated natural gas from the upward revisions in oil reserves. For ventures accounted for by the equity method, increases in natural gas prices accounted for about 46,000 Mcf of the upward revisions in natural gas reserves and the remaining upward revisions in natural gas reserves are from better than expected performance from nine Barnett Shale wells that were classified as proved developed non-producing at year-end 2009. These long-lateral horizontal wells began production in first quarter 2010.

In 2009, the upward revision in oil reserves was predominately attributable to stimulation treatments to two existing wells, remedial work on a high volume oil well, improved performance from a change in the operating conditions of a natural water drive reservoir, addition of natural gas liquids reserves and reactivation of idle oil wells. The downward revision in natural gas reserves is largely due to accounting for consumption of natural gas in operations and sale of dry natural gas volumes. This consumption of natural gas, shrink of natural gas due to processing, and the amounts of natural gas liquids production and sales, were not known when estimating reserves for year-end 2008 as our new processes to obtain such information were not in place.

In 2011, 2010 and 2009, reserve additions from new wells drilled and completed during the year are shown for both consolidated entities and ventures accounted for using the equity method under extensions and discoveries. There were 36 new well additions in 2011, 22 new well additions in 2010 and 30 new well additions in 2009.

In 2009, the effect of applying twelve month average prices, versus 2009 year-end prices of $76.00 per barrel and $5.79 per MMBTU of natural gas, decreased net remaining reserve volumes by 8 percent of total proved reserves. We do not have any estimated reserves of synthetic oil, synthetic natural gas or products of other non-renewable natural resources that are intended to be upgraded into synthetic oil and natural gas.

Capitalized Cost Relating to Oil and Natural Gas Producing Activities

Capitalized cost related to our oil and natural gas producing activities are as follows:

	At Year-End (In thousands)		
	2011	**2010**	**2009**
Consolidated entities:			
Proved oil and natural gas properties	$ 4,002	$ 456	$ 450
Unproved oil and natural gas properties	714		
Accumulated depreciation, depletion and amortization	(155)	(134)	(69)
Net capitalized costs	$ 4,561	$ 322	$ 381

We have not capitalized any costs for our share in ventures accounted for using the equity method. Proved oil and natural gas properties increased in 2011 due to our participation as a non-operating working interest owner in two wells. Unproved oil and natural gas properties increased as a result of our acquisition of unproved leasehold on approximately 13,000 net mineral acres in Alabama and Georgia. Accumulated depreciation, depletion and amortization represents our proportional share of exploration and development costs related to our non-operating working interest in wells that began production in 2009 and 2011.

Table of Contents

Costs Incurred in Oil and Natural Gas Property Acquisition, Exploration and Development

Costs incurred in oil and natural gas property acquisition, exploration and development activities, whether capitalized or expensed, follows:

	2011	For the Year 2010 (In thousands)	2009
Consolidated entities:			
Acquisition of properties	$ 714	$	$
Exploration costs	549		209
Development costs	3,597	5	215
Total cost incurred for consolidated entities	**$ 4,860**	**$ 5**	**$ 424**

We have not incurred any costs for our share in ventures accounted for using the equity method. Acquisition of properties represents unproved leasehold associated with 13,000 net mineral acres in Alabama and Georgia acquired in 2011. Development costs have increased due to our participation as a non-operating working interest owner in two wells during 2011.

Standardized Measure of Discounted Future Net Cash Flows

Estimates of future cash flows from proved developed oil and natural gas reserves are shown in the following table. Estimated income taxes are calculated by applying the appropriate tax rates to the estimated future pre-tax net cash flows less depreciation of the tax basis of properties and the statutory depletion allowance.

	2011	At Year-End 2010 (In thousands)	2009
Consolidated entities:			
Future cash inflows	$ 142,043	$ 74,264	$ 57,416
Future production and development costs	(18,929)	(9,003)	(8,379)
Future income tax expenses	(38,681)	(20,570)	(15,362)
Future net cash flows	84,433	44,691	33,675
10% annual discount for estimated timing of cash flows	(31,735)	(17,881)	(12,537)
Standardized measure of discounted future net cash flows	$ 52,698	$ 26,810	$ 21,138
Our share in ventures accounted for using the equity method:			
Future cash inflows	$ 12,346	$ 15,748	$ 8,265
Future production and development costs	(1,731)	(3,545)	(886)
Future income tax expenses	(3,154)	(3,542)	(2,333)
Future net cash flows	7,461	8,661	5,046
10% annual discount for estimated timing of cash flows	(3,953)	(4,334)	(2,374)
Standardized measure of discounted future net cash flows	$ 3,508	$ 4,327	$ 2,672
Total consolidated and our share of equity method ventures	$ 56,206	$ 31,137	$ 23,810

Future net cash flows were computed using prices used in estimating proved developed oil and natural gas reserves, year-end costs, and statutory tax rates (adjusted for tax deductions) that relate to proved developed oil and natural gas reserves.

Table of Contents

Changes in the standardized measure of discounted future net cash flow follow:

	Consolidated	For the Year Our Share of Equity Method Ventures (In thousands)	Total
Year-end 2008	$ 21,885	$ 188	$ 22,073
Changes resulting from:			
Net change in sales prices and production costs	(3,043)	(97)	(3,140)
Sales of oil and natural gas, net of production costs	(11,157)	(299)	(11,456)
Net change due to extensions and discoveries	4,139	3,844	7,983
Net change due to revisions of quantity estimates	5,693	1,169	6,862
Accretion of discount	2,408	21	2,429
Net change in income taxes	1,213	(2,154)	(941)
Aggregate change for the year	$ (747)	$ 2,484	$ 1,737
Year-end 2009	$ 21,138	$ 2,672	$ 23,810
Changes resulting from:			
Net change in sales prices and production costs	9,929	939	10,868
Sales of oil and natural gas, net of production costs	(12,690)	(2,104)	(14,794)
Net change due to extensions and discoveries	2,148	1,526	3,674
Net change due to revisions of quantity estimates	9,153	2,224	11,377
Accretion of discount	2,340	279	2,619
Net change in income taxes	(5,208)	(1,209)	(6,417)
Aggregate change for the year	$ 5,672	$ 1,655	$ 7,327
Year-end 2010	$ 26,810	$ 4,327	$ 31,137
Changes resulting from:			
Net change in sales prices and production costs	8,476	153	8,629
Sales of oil and natural gas, net of production costs	(17,747)	(1,622)	(19,369)
Net change due to extensions and discoveries	32,671		32,671
Net change due to revisions of quantity estimates	17,586	(204)	17,382
Accretion of discount	3,013	466	3,479
Net change in income taxes	(18,111)	388	(17,723)
Aggregate change for the year	$ 25,888	$ (819)	$ 25,069
Year-end 2011	$ 52,698	$ 3,508	$ 56,206

Table of Contents

Results of Operations for Oil and Natural Gas Producing Activities

Our royalty interests are contractually defined and based on a percentage of production at prevailing market prices. We receive our percentage of production in cash. Our royalty revenues fluctuate based on changes in the market prices for oil and natural gas, the inevitable decline in production in existing wells, and other factors affecting the third-party oil and natural gas exploration and production companies, including the cost of development and production.

Information about the results of operations of our oil and natural gas interests follows:

	For the Year		
	2011	2010	2009
		(In thousands)	
Consolidated entities:			
Royalty revenues	$ 19,239	$ 13,724	$ 11,910
Production costs	(1,492)	(1,032)	(753)
Exploration expenses	(549)		(100)
Depreciation, depletion, amortization	(337)	(334)	(253)
Oil and natural gas administrative expenses	(4,445)	(3,295)	(3,546)
Income tax expenses	(3,645)	(2,637)	(2,200)
Results of operations	$ 8,771	$ 6,426	$ 5,058
Our share in ventures accounted for using the equity method:[a]			
Royalty revenues	$ 1,882	$ 2,359	$ 312
Production costs	(260)	(255)	(13)
Exploration expenses			
Depreciation, depletion, amortization			
Oil and natural gas administrative expenses	(228)	(70)	(18)
Income tax expenses	(400)	(605)	(84)
Results of operations	$ 994	$ 1,429	$ 197
Total results of operations	$ 9,765	$ 7,855	$ 5,255

(a) Producing wells in ventures accounted for using the equity method began generating royalties in 2009.
Production costs represent our share of oil and natural gas production severance taxes and lease operating expenses.

Oil and natural gas produced and average unit prices related to our royalty and non-operating working interests follows:

	For the Year		
	2011	2010	2009
Consolidated entities:			
Oil production (barrels)	151,900	115,400	107,200
Average price per barrel	$ 96.84	$ 73.09	$ 56.85
Natural gas production (millions of cubic feet)	1,128.6	1,223.6	1,411.6
Average price per thousand cubic feet	$ 4.01	$ 4.32	$ 4.12
Our share of ventures accounted for using the equity method:			
Natural gas production (millions of cubic feet)	493.4	572.8	82.1
Average price per thousand cubic feet	$ 3.81	$ 4.12	$ 3.80
Total consolidated and our share of equity method ventures:			
Oil production (barrels)	151,900	115,400	107,200
Average price per barrel	$ 96.84	$ 73.09	$ 56.85

Natural gas production (millions of cubic feet)	1,622.0	1,796.4	1,493.7
Average price per thousand cubic feet	$ 3.95	$ 4.26	$ 4.10

Table of Contents

Note 22 Summary of Quarterly Results of Operations (Unaudited)

Summarized quarterly financial results for 2011 and 2010 follows:

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(In thousands, except per share amounts)			
2011				
Total revenues	$ 29,840	$ 25,485	$ 26,241	$ 54,007
Gross profit	18,629	14,405	12,928	22,646
Operating income (loss)	984	(2,927)	60,171	(113)
Equity in earnings (loss) of unconsolidated ventures	582	402	648	(30,841)
Income (loss) before taxes	(2,416)	(7,154)	56,574	(34,742)
Net income (loss) attributable to Forestar Group Inc.	(2,473)	(3,921)	36,428	(22,880)
Net income (loss) per share basic	(0.07)	(0.11)	1.03	(0.65)
Net income (loss) per share diluted	(0.07)	(0.11)	1.02	(0.65)
2010				
Total revenues	$ 26,358	$ 28,137	$ 24,013	$ 22,852
Gross profit	15,214	16,032	15,210	6,682
Operating income (loss)	(571)	684	15,531	3,241
Equity in earnings of unconsolidated ventures	371	287	82	3,961
Income (loss) before taxes	(4,548)	(2,886)	11,946	3,792
Net income (loss) attributable to Forestar Group Inc.	(2,972)	(3,273)	8,922	2,448
Net income (loss) per share basic	(0.08)	(0.09)	0.25	0.07
Net income (loss) per share diluted	(0.08)	(0.09)	0.25	0.07

Note 23 Subsequent Events

On January 20, 2012, we sold our 25% interest in Palisades West LLC to Dimensional Fund Advisors L.P. for approximately $32,095,000, resulting in a pre-tax gain of approximately $11,675,000.

On February 20, 2012, we entered into definitive agreements with CL Realty, L.L.C. and TEMCO Associates, LLC, as applicable, and Cousins Real Estate Corporation, to acquire the ventures entire interest in 17 residential and mixed-use real estate projects for an aggregate cash purchase price of $47,000,000. Accounting pronouncements require the ventures to carry the assets to be sold at their estimated fair values, which are the agreed upon sales prices. Accordingly, the ventures 2011 year-end operating results include $44,681,000 ($23,255,000 at CL Realty and $21,426,000 at TEMCO) of non-cash impairments related to entering into these agreements. Our share of these non-cash impairment charges was $22,341,000 ($11,628,000 at CL Realty and $10,713,000 at TEMCO) and is included in equity in earnings (loss) of unconsolidated ventures at year-end 2011.

Please read Note 7 for additional information about these ventures.

Table of Contents

Schedule III Schedule III Consolidated Real Estate and Accumulated Depreciation

Forestar Group Inc.

Schedule III Consolidated Real Estate and Accumulated Depreciation

Year-End 2011

(In thousands)

		Initial Cost to Company		Costs Capitalized Subsequent to Acquisition		Gross Amount Carried at End of Period					
Description	**Encumbrances**	**Land**	**Buildings & Improvements**	**Improvements less Cost of Sales and Other**	**Carrying Costs[a]**	**Land & Land Improvements**	**Buildings & Improvements**	**Total**	**Accumulated Depreciation**	**Date of Construction**	**Date Acquired**
Entitled, Developed, and Under Development Projects:											
CALIFORNIA											
Contra Costa County											
San Joaquin River		$ 12,225		$ (3,430)		$ 8,795		$ 8,795			
COLORADO											
Douglas County											
Pinery West		7,308		2,198		9,506		9,506		2006	2006
Weld County											
Buffalo Highlands		3,001		582		3,583		3,583		2006	2005
Johnstown Farms		2,749		3,894	$ 188	6,831		6,831		2002	2002
Stonebraker		3,878		(1,282)		2,596		2,596		2005	2005
GEORGIA											
Bartow County											
Towne West		936		923		1,859		1,859			
Euharlee North		269		138		407		407			
Parkside at Woodbury		134		374		508		508			
Coweta County											
Cedar Creek Preserve		852		251		1,103		1,103			
Corinth Landing		607		585		1,192		1,192			
Coweta South Industrial Park		532		477		1,009		1,009			
Fox Hall		166		2,239		2,405		2,405			
Genesee		480		1,170		1,650		1,650			
Dawson County, Georgia											
Woodlands at Burt Creek		71		1,670		1,741		1,741			
TEXAS											
Bastrop County											
Hunter s Crossing		3,613		6,684	326	10,623		10,623		2001	2001
The Colony		8,726		13,339	161	22,226		22,226		1999	1999
Bexar County											

Cibolo Canyons		25,569	53,377	1,485	80,431	80,431	2004	1986
Calhoun County								
Caracol	$ 7,367	8,603	4,026	2,047	14,676	14,676	2006	2006
Harbor Mist		2,822			2,822	2,822		2007

92

Table of Contents

Forestar Group Inc.

Schedule III Consolidated Real Estate and Accumulated Depreciation

Year-End 2011

(In thousands)

		Initial Cost to Company		Costs Capitalized Subsequent to Acquisition		Gross Amount Carried at End of Period					
Description	**Encumbrances**	**Land**	**Buildings & Improvements**	**Improvements less Cost of Sales and Other**	**Carrying Costs[a]**	**Land & Land Improvements**	**Buildings & Improvements**	**Total**	**Accumulated Depreciation**	**Date of Construction**	**Date Acquired**
Collin County											
Light Farms	$ 30,818	$ 30,102		$ 21,300		$ 51,402		$ 51,402		2000	2007
Maxwell Creek		9,904		(56)	$ 629	10,477		10,477		2000	2000
The Gables at North Hill		2,160		(2,223)	63					2004	2001
Timber Creek	3,431	7,282		2,971		10,253		10,253		2007	2007
Comal County											
Oak Creek Estates		1,921		2,430	175	4,526		4,526		2006	2005
Dallas County											
Stoney Creek		12,822		2,287		15,109		15,109		2007	2007
Denton County											
Lantana	8,071	31,451		4,116		35,567		35,567		2000	1999
The Preserve at Pecan Creek		5,855		(1,324)	366	4,897		4,897		2006	2005
Harris County											
Barrington		8,950		(71)		8,879		8,879			2011
City Park		3,946		(2,745)	1,641	2,842		2,842		2002	2001
Hays County											
Arrowhead Ranch		12,856		1,910		14,766		14,766			2007
Hood County											
Harbor Lakes		3,514		390	311	4,215		4,215		2000	1998
Nueces County											
Tortuga Dunes		12,080		10,893		22,973		22,973			2006
Williamson County											
Westside at Buttercup Creek		13,148		(9,402)	449	4,195		4,195		1993	1993
Chandler Road Properties		3,552		(2,822)		730		730		2004	2004
La Conterra		4,023		2,816	293	7,132		7,132			2006
MISSOURI											
Clay County											
Somerbrook		3,061		(219)	13	2,855		2,855		2003	2001
Other		18,054		(10,600)	791	8,245		8,245			
Total Entitled, Developed, and Under Development Projects	**$ 49,687**	**$ 267,222**	**$**	**$ 106,866**	**$ 8,938**	**$ 383,026**	**$**	**$ 383,026**	**$**		
Undeveloped Land:											
CALIFORNIA											

Los Angeles County

93

Table of Contents

Forestar Group Inc.

Schedule III Consolidated Real Estate and Accumulated Depreciation

Year-End 2011

(In thousands)

		Initial Cost to Company		Costs Capitalized Subsequent to Acquisition		Gross Amount Carried at End of Period					
Description	**Encumbrances**	**Land**	**Buildings & Improvements**	**Improvements less Cost of Sales and Other**	**Carrying Costs(a**	**Land & Land Improvements**	**Buildings & Improvements**	**Total**	**Accumulated Depreciation**	**Date of Construction**	**Date Acquired**
Land In Entitlement Process		$ 3,969		$ 10,095		$ 14,064		$ 14,064			1997
GEORGIA											
Bartow County											
Undeveloped Land		4,397		87		4,484		4,484			
Land In Entitlement Process											
Carroll County											
Undeveloped Land		6,651		132		6,783		6,783			
Land In Entitlement Process		9,308		2,343		11,651		11,651			
Cherokee County											
Undeveloped Land		3,522		95		3,617		3,617			
Land In Entitlement Process		2,412		563		2,975		2,975			
Coweta County											
Undeveloped Land		485		108		593		593			
Land In Entitlement Process		2,793		572		3,365		3,365			
Dawson County											
Undeveloped Land		2,292		9		2,301		2,301			
Land In Entitlement Process											
Gilmer County											
Undeveloped Land		2,976		22		2,998		2,998			
Lumpkin County											
Undeveloped Land		3,117		4		3,121		3,121			
Paulding County											
Undeveloped Land		1,406		242		1,648		1,648			
Pickens County											
Undeveloped Land		2,409		29		2,438		2,438			
TEXAS											
Harris County											
Land in Entitlement Process		685		891		1,576		1,576			
San Augustine County											
Undeveloped Land		1,610				1,610		1,610			
Other											
Undeveloped Land		11,154		3,946		15,100		15,100			

Table of Contents

Forestar Group Inc.

Schedule III Consolidated Real Estate and Accumulated Depreciation

Year-End 2011

(In thousands)

		Initial Cost to Company		Costs Capitalized Subsequent to Acquisition		Gross Amount Carried at End of Period					
Description	**Encumbrances**	**Land**	**Buildings & Improvements**	**Improvements less Cost of Sales and Other**	**Carrying Costs[a]**	**Land & Land Improvements**	**Buildings & Improvements**	**Total**	**Accumulated Depreciation**	**Date of Construction**	**Date Acquired**
Land in Entitlement Process		3,179		(1,427)		1,752		1,752			
Total Undeveloped Land	**$**	**$ 62,365**	**$**	**$ 17,711**	**$**	**$ 80,076**	**$**	**$ 80,076**	**$**		
<u>Income Producing Properties:</u>											
TEXAS											
Dallas County											
Undeveloped Multifamily site		$ 2,266		$ 1,507		$ 3,773		$ 3,773		2011	2011
Harris County											
Broadstone Memorial	$ 26,500	4,701	$ 43,323	69		4,701	$ 43,392	48,093	$ (1,435)		
Travis County											
Radisson Hotel & Suites	15,400		16,316	29,164			45,480	45,480	(24,285)		
Promesa		2,872		10,215	$ 342	13,429		13,429		2006	2006
Undeveloped Multifamily site		6,406		465		6,871		6,871		2011	2011
Hood County											
Harbor Lakes Golf Club			1,446	1,601			3,047	3,047	(1,235)	2000	1998
COLORADO											
Arapahoe County											
Undeveloped Multifamily site		7,309		1,218		8,527		8,527			2011
Total Income Producing Properties	**$ 41,900**	**$ 23,554**	**$ 61,085**	**$ 44,239**	**$ 342**	**$ 37,301**	**$ 91,919**	**$ 129,220**	**$ (26,955)**		
Total	**$ 91,587**	**$ 353,141**	**$ 61,085**	**$ 168,816**	**$ 9,280**	**$ 500,403**	**$ 91,919**	**$ 592,322**	**$ (26,955)**		

[a] We do not capitalize carrying costs until development begins.

Table of Contents

Reconciliation of real estate:

	2011	2010 (In thousands)	2009
Balance at beginning of year	$ 585,090	$ 567,229	$ 633,130
Amounts capitalized	66,338	65,024	38,971
Amounts retired or adjusted	(59,106)	(47,163)	(104,872)
Balance at close of period	$ 592,322	$ 585,090	$ 567,229

Reconciliation of accumulated depreciation:

	2011	2010 (In thousands)	2009
Balance at beginning of year	$ (23,438)	$ (24,417)	$ (22,544)
Depreciation expense	(3,547)	(2,582)	(1,873)
Amounts retired or adjusted	30	3,561	
Balance at close of period	$ (26,955)	$ (23,438)	$ (24,417)

Item 9. ***Changes in and Disagreements With Accountants on Accounting and Financial Disclosure.***
None.

Item 9A. ***Controls and Procedures.***
(a) Disclosure controls and procedures

Our management, with the participation of the Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (or the Exchange Act)) as of the end of the period covered by this report. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, our disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by us in the reports that we file or submit under the Exchange Act and are effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

(b) Internal control over financial reporting

Management s report on internal control over financial reporting is included in Part II, Item 8 of this Annual Report on Form 10-K.

(c) Changes in Internal Control over Financial Reporting

There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. ***Other Information.***

None.

Table of Contents

PART III

Item 10. ***Directors, Executive Officers and Corporate Governance.***
Set forth below is certain information about the members of our Board of Directors:

Name	Age	Year First Elected to the Board	Principal Occupation
Kenneth M. Jastrow, II	64	2007	Non-Executive Chairman of Forestar Group Inc.
Louis R. Brill	70	2007	Former Chief Accounting Officer of Temple-Inland Inc.
Kathleen Brown	66	2007	Chairman of Investment Banking for the Midwest Region, Goldman, Sachs & Co.
William G. Currie	64	2007	Chairman of Universal Forest Products, Inc.
James M. DeCosmo	53	2007	President and Chief Executive Officer of Forestar Group Inc.
Michael E. Dougherty	71	2008	Founder and Chairman of Dougherty Financial Group LLC
James A. Johnson	68	2007	Vice Chairman of Perseus LLC
William C. Powers, Jr.	65	2007	President of The University of Texas at Austin
James A. Rubright	65	2007	Chairman and Chief Executive Officer of Rock-Tenn Company
Richard M. Smith	66	2007	President of Pinkerton Foundation
Carl A. Thomason	59	2012	President of Great Northern Gathering and Marketing, LLC

The remaining information required by this item is incorporated herein by reference from our definitive proxy statement, involving the election of directors, to be filed pursuant to Regulation 14A with the SEC not later than 120 days after the end of the fiscal year covered by this Form 10-K (or Definitive Proxy Statement). Certain information required by this item concerning executive officers is included in Part I of this report.

Item 11. ***Executive Compensation.***
The information required by this item is incorporated by reference from our Definitive Proxy Statement.

Item 12. ***Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.***
Equity Compensation Plan Information

We have only one equity compensation plan, the Forestar 2007 Stock Incentive Plan. It was approved by our sole stockholder prior to spin-off and material terms were subsequently approved by our stockholders. Information at year-end 2011 about our equity compensation plan under which our common stock may be issued follows:

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights[(1)(2)]	Weighted-Average Exercise Price of Outstanding Options, Warants and Rights	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities

	(a)	(b)	Reflected in Column (a)) (c)
Equity compensation plans approved by security holders	2,715,120	$ 21.96	2,408,087
Equity compensation plans not approved by security holders	None	None	None
Total	2,715,120	$ 21.96	2,408,087

(1) Includes approximately 1,107,000 issuable to personnel of Temple-Inland and the other spin-off entity resulting from the equitable adjustment of Temple-Inland equity awards in connection with our spin-off.

(2) Includes approximately 129,000 equity-settled restricted stock units and 124,700 market-leveraged stock units, which are excluded from the calculation of weighted-average exercise price. The market-leveraged stock unit awards will be settled in common stock based upon our stock price performance over three years from the date of grant. The number of shares to be issued could range from a high of 187,050 shares if our stock price increases by 50 percent or more, to a low of 62,350 shares if our stock price decreases by 50 percent, or could be zero if our stock price decreases by more than 50 percent, the minimum threshold performance.

The remaining information required by this item is incorporated by reference from our Definitive Proxy Statement.

Item 13. ***Certain Relationships and Related Transactions, and Director Independence.***

The information required by this item is incorporated by reference from our Definitive Proxy Statement.

Item 14. ***Principal Accountant Fees and Services.***

The information required by this item is incorporated by reference from our Definitive Proxy Statement.

PART IV

Item 15. ***Exhibits and Financial Statement Schedules.***

(a) Documents filed as part of this report.

(1) *Financial Statements*

Our Consolidated Financial Statements are included in Part II, Item 8 of this Annual Report on Form 10-K.

(2) *Financial Statement Schedules*

Schedule III Consolidated Real Estate and Accumulated Depreciation is included in Part II, Item 8 of this Annual Report on Form 10-K.

Schedules other than those listed above are omitted as the required information is either inapplicable or the information is presented in our Consolidated Financial Statements and notes thereto.

(3) *Exhibits*

The exhibits listed in the Exhibit Index in (b) below are filed or incorporated by reference as part of this Annual Report on Form 10-K.

(b) Exhibits

Exhibit Number	Exhibit
2.1	

	Separation and Distribution Agreement, dated December 11, 2007, among Forestar Real Estate Group Inc. (the Company), Guaranty Financial Group Inc., and Temple Inland Inc. (incorporated by reference to Exhibit 2.1 of the Company s Current Report on Form 8-K filed with the Commission on December 11, 2007).
3.1	Amended and Restated Certificate of Incorporation (incorporated by reference to Exhibit 3.1 of the Company s Current Report on Form 8-K filed with the Commission on December 11, 2007).

Table of Contents

Exhibit Number	Exhibit
3.2	Amended and Restated Bylaws (incorporated by reference to Exhibit 3.2 of the Company s Current Report on Form 8-K filed with the Commission on December 11, 2007).
3.3	First Amendment to Amended and Restated Bylaws of Forestar Real Estate Group Inc. (incorporated by reference to Exhibit 3.1 of the Company s Current Report on Form 8-K filed with the Commission on February 19, 2008).
3.4	Certificate of Designation of Series A Junior Participating Preferred Stock (incorporated by reference to Exhibit 3.3 of the Company s Current Report on Form 8-K filed with the Commission on December 11, 2007).
3.5	Second Amendment to Amended and Restated Bylaws of Forestar Real Estate Group Inc. (incorporated by reference to Exhibit 3.5 of the Company s Annual Report on Form 10-K filed with the Commission on March 5, 2009)
3.6	Certificate of Ownership and Merger, dated November 21, 2008 (incorporated by reference to Exhibit 3.1 of the Company s Current Report on Form 8-K filed with the Commission on November 24, 2008).
3.7	Third Amendment to Amended and Restated Bylaws of Forestar Group Inc. (incorporated by reference to Exhibit 3.2 of the Company s Current Report on Form 8-K filed with the Commission on November 24, 2008).
4.1	Specimen Certificate for shares of common stock, par value $1.00 per share, of Forestar Real Estate Group Inc. (incorporated by reference to Exhibit 4.1 of Amendment No. 5 to the Company s Form 10 filed with the Commission on December 10, 2007).
4.2	Rights Agreement, dated December 11, 2007, between Forestar Real Estate Group Inc. and Computershare Trust Company, N.A., as Rights Agent (including Form of Rights Certificate) (incorporated by reference to Exhibit 4.1 of the Company s Current Report on Form 8-K filed with the Commission on December 11, 2007).
10.1	Tax Matters Agreement, dated December 11, 2007, among Forestar Real Estate Group Inc., Guaranty Financial Group Inc., and Temple Inland Inc. (incorporated by reference to Exhibit 10.1 of the Company s Current Report on Form 8-K filed with the Commission on December 11, 2007).
10.2	Transition Services Agreement, dated December 11, 2007, among Forestar Real Estate Group Inc., Guaranty Financial Group Inc., and Temple Inland Inc. (incorporated by reference to Exhibit 10.2 of the Company s Current Report on Form 8-K filed with the Commission on December 11, 2007).
10.3	Employee Matters Agreement, dated December 11, 2007, among Forestar Real Estate Group Inc., Guaranty Financial Group Inc., and Temple Inland Inc. (incorporated by reference to Exhibit 10.3 of the Company s Current Report on Form 8-K filed with the Commission on December 11, 2007).
10.4	Form of Forestar Real Estate Group Supplemental Employee Retirement Plan (incorporated by reference to Exhibit 10.5 of Amendment No. 5 to the Company s Form 10 filed with the Commission on December 10, 2007).
10.5	Form of Forestar Real Estate Group 2007 Stock Incentive Plan (incorporated by reference to Exhibit 10.6 of Amendment No. 5 to the Company s Form 10 filed with the Commission on December 10, 2007).
10.6	Form of Forestar Real Estate Group Director s Fee Deferral Plan (incorporated by reference to Exhibit 10.7 of Amendment No. 5 to the Company s Form 10 filed with the Commission on December 10, 2007).
10.7	Form of Indemnification Agreement to be entered into between the Company and each of its directors (incorporated by reference to Exhibit 10.9 of Amendment No. 5 to the Company s Form 10 filed with the Commission on December 10, 2007).
10.8	Form of Change in Control Agreement between the Company and its named executive officers (incorporated by reference to Exhibit 10.10 of Amendment No. 5 to the Company s Form 10 filed with the Commission on December 10, 2007).
10.9	Employment Agreement between the Company and James M. DeCosmo dated August 9, 2007 (incorporated by reference to Exhibit 10.11 of Amendment No. 5 to the Company s Form 10 filed with the Commission on December 10, 2007).

Exhibit Number	Exhibit
10.10	Form of Nonqualified Stock Option Agreement (incorporated by reference to Exhibit 10.12 of the Company s Annual Report on Form 10-K filed with the Commission on March 5, 2009).
10.11	Form of Restricted Stock Agreement (Tier 1) (incorporated by reference to Exhibit 10.13 of the Company s Annual Report on Form 10-K filed with the Commission on March 5, 2009).
10.12	Form of Restricted Stock Units Agreement for senior executives (incorporated by reference to Exhibit 10.2 of the Company s Current Report on Form 8-K filed with the Commission on February 12, 2009).
10.13	Form of Stock Appreciation Rights Agreement (incorporated by reference to Exhibit 10.1 of the Company s Current Report on Form 8-K filed with the Commission on February 12, 2009).
10.14	First Amendment to Forestar Group Inc. Director s Fee Deferral Plan (incorporated by reference to Exhibit 10.16 of the Company s Annual Report on Form 10-K filed with the Commission on March 5, 2009).
10.15	First Amendment to the Forestar Real Estate Group Inc. 2007 Stock Incentive Plan (incorporated by reference to Exhibit 10.1 of the Company s Current Report on Form 8-K filed with the Commission on May 13, 2009).
10.16	Second Amendment to the Forestar Group Inc. 2007 Stock Incentive Plan (incorporated by reference to Exhibit 10.22 to the Company s Annual Report on Form 10-K filed with the Commission on March 3, 2010).
10.17	Amended and Restated Revolving and Term Credit Agreement, dated as of August 6, 2010, by and among the Company, Forestar (USA) Real Estate Group Inc. and its wholly-owned subsidiaries signatory thereto, KeyBank National Association, as administrative agent, and the lenders party thereto (incorporated by reference to Exhibit 10.1 of the Company s Current Report on Form 8-K filed with the Commission on August 6, 2010).
10.18	Supplement dated February 23, 2011 to the Amended and Restated Revolving and Term Credit Agreement, by and between Forestar (USA) Real Estate Group Inc., KeyBank National Association, and JP Morgan Chase Bank, National Association (incorporated by reference to Exhibit 10.1 of the Company s Current Report on Form 8-K filed with the Commission on February 24, 2011).
10.19	Severance Agreement dated October 12, 2009, by and between the Company and Phillip J. Weber (incorporated by reference to Exhibit 10.22 of the Company s Annual Report on Form 10-K filed with the Commission on March 2, 2011).
10.20	First Amendment to Employment Agreement, dated as of November 10, 2010, by and between the Company and James M. DeCosmo (incorporated by reference to Exhibit 10.23 of the Company s Annual Report on Form 10-K filed with the Commission on March 2, 2011).
10.21	Form of Market-Leveraged Stock Unit Award Agreement (incorporated by reference to Exhibit 10.1 of the Company s Current Report on Form 8-K filed with the Commission on February 9, 2011).
10.22 *	Form of Indemnification Agreement entered into between the Company and each of its executive officers.
10.23	Purchase and Sale Agreement dated July 6, 2011, by and among Forestar (USA) Real Estate Group Inc., as seller, Plum Creek Timberlands, L.P., as purchaser, and First American Title Insurance Company, as escrow agent, as amended by First Amendment to Purchase and Sale Agreement dated July 29, 2011, by and among Forestar (USA) Real Estate Group Inc., Plum Creek Timberlands, L.P., and First American Title Insurance Company (incorporated by reference to Exhibit 10.1 of the Company s Quarterly Report on Form 10-Q filed with the Commission on November 3, 2011).
10.24	First Amendment to Amended and Restated Revolving and Term Credit Agreement, dated as of May 6, 2011, by and among Forestar (USA) Real Estate Group Inc., certain wholly-owned subsidiaries signatory thereto, KeyBank National Association, as administrative agent, and the lenders party thereto (incorporated by reference to Exhibit 99.1 of the Company s Current Report on Form 8-K filed with the Commission on May 31, 2011).

Table of Contents

Exhibit Number	Exhibit
10.25	Second Amendment to Amended and Restated Revolving and Term Credit Agreement, dated as of September 30, 2011, by and among the Company, Forestar (USA) Real Estate Group Inc. and its wholly-owned subsidiaries signatory thereto, KeyBank National Association, as administrative agent, and the lenders party thereto (incorporated by reference to Exhibit 10.1 of the Company s Current Report on Form 8-K filed with the Commission on October 3, 2011).
10.26	Exercise of option to extend revolving credit maturity date under Amended and Restated Revolving and Term Credit Agreement, dated September 30, 2011, by Forestar (USA) Real Estate Group Inc. (incorporated by reference to Exhibit 10.1 of the Company s Quarterly Report on Form 10-Q filed with the Commission on November 3, 2011).
10.27	Assignment and Assumption of Membership Interest dated January 20, 2012, executed by Forestar (USA) Real Estate Group Inc. and Dimensional Fund Advisors LP (incorporated by reference to Exhibit 10.1 of the Company s Current Report on Form 8-K filed with the Commission on January 24, 2012).
21.1*	List of Subsidiaries of the Company.
23.1*	Consent of Ernst & Young LLP.
23.2*	Consent of Netherland, Sewell & Associates, Inc.
23.3*	Consent of Ernst & Young LLP.
23.4*	Consent of Ernst & Young LLP.
31.1*	Certification of Chief Executive Officer pursuant to Exchange Act rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certification of Chief Financial Officer pursuant to Exchange Act rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1*	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2*	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
99.1*	Reserve report of Netherland, Sewell & Associates, Inc., dated January 24, 2012.
99.2*	C.L. Realty, L.L.C. Consolidated Financial Statements for the years ended December 31, 2011, 2010 and 2009 (with Independent Auditors Report).
99.3*	TEMCO Associates, LLC Consolidated Financial Statements for the years ended December 31, 2011, 2010 and 2009 (with Independent Auditors Report).
101.1*	The following materials from the Company s Annual Report on Form 10-K for the year ended December 31, 2011, formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Cash Flows, and (iv) Notes to Consolidated Financial Statements, tagged as blocks of text.

* Filed herewith.

Management contract or compensatory plan or arrangement.

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

FORESTAR GROUP INC.

By: /s/ James M. DeCosmo
James M. DeCosmo
President and Chief Executive Officer

Date: March 7, 2012

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Capacity	Date
/s/ James M. DeCosmo James M. DeCosmo	Director, President and Chief Executive Officer (Principal Executive Officer)	March 7, 2012
/s/ Christopher L. Nines Christopher L. Nines	Chief Financial Officer (Principal Financial Officer)	March 7, 2012
/s/ Charles D. Jehl Charles D. Jehl	Chief Accounting Officer (Principal Accounting Officer)	March 7, 2012
/s/ Kenneth M. Jastrow, II Kenneth M. Jastrow, II	Non-Executive Chairman of the Board	March 7, 2012
/s/ Louis R. Brill Louis R. Brill	Director	March 7, 2012
/s/ Kathleen Brown Kathleen Brown	Director	March 7, 2012
/s/ William G. Currie William G. Currie	Director	March 7, 2012
/s/ Michael E. Dougherty Michael E. Dougherty	Director	March 7, 2012
/s/ James A. Johnson James A. Johnson	Director	March 7, 2012
/s/ William C. Powers, Jr. William C. Powers, Jr.	Director	March 7, 2012

/s/ James A. Rubright James A. Rubright	Director	March 7, 2012
/s/ Richard M. Smith Richard M. Smith	Director	March 7, 2012
/s/ Carl A. Thomason Carl A. Thomason	Director	March 7, 2012