

AMREIT
Form 10-Q
August 14, 2007

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

FORM 10-Q

**[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES
EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2007

**[] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES
EXCHANGE ACT OF 1934**

For the transition period from _____ to _____

Commission File Number: 0-28378

AmREIT

(Name of registrant as specified its charter)

TEXAS

(State or Other Jurisdiction of Incorporation or
Organization)

76-0410050

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

**8 GREENWAY PLAZA, SUITE 1000
HOUSTON, TX**

(Address of Principal Executive Offices)

77046

(Zip Code)

713-850-1400

(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 issuer 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. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer " Accelerated Filer " Non-Accelerated Filer x

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

As of August 10, 2007 there were 6,392,071 class A, 1,031,779 class B, 4,113,986 class C and 10,970,035 class D common shares of beneficial interest of AmREIT, \$.01 par value per share, outstanding.

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PART I- FINANCIAL INFORMATION

Item 1. Financial Statements

AmREIT AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
June 30, 2007 and December 31, 2006
(in thousands, except share data)

| | June 30, 2007 | December 31, 2006 |
|---|-------------------|-------------------------|
| | (unaudited) | |
| ASSETS | | |
| Real estate investments at cost: | | |
| Land | \$ 133,249 | \$ 124,751 |
| Buildings | 139,378 | 140,487 |
| Tenant improvements | 9,729 | 9,296 |
| | 282,356 | 274,534 |
| Less accumulated depreciation and amortization | (13,124) | (10,628) |
| | 269,232 | 263,906 |
| Real estate held for sale, net | 1,763 | - |
| Net investment in direct financing leases held for investment | 19,181 | 19,204 |
| Intangible lease cost, net | 14,548 | 16,016 |
| Investment in merchant development funds and other affiliates | 3,253 | 2,651 |
| Net real estate investments | 307,977 | 301,777 |
| Cash and cash equivalents | 4,356 | 3,415 |
| Tenant receivables, net | 3,974 | 4,330 |
| Accounts receivable, net | 1,447 | 1,772 |
| Accounts receivable - related party | 1,787 | 1,665 |
| Notes receivable - related party | 6,776 | 10,104 |
| Deferred costs | 2,303 | 2,045 |
| Other assets | 4,372 | 3,322 |
| TOTAL ASSETS | \$ 332,992 | \$ 328,430 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Liabilities: | | |
| Notes payable | \$ 157,545 | \$ 144,453 |
| Accounts payable and other liabilities | 5,220 | 9,162 |
| Below market leases, net | 3,676 | 3,960 |
| Security deposits | 679 | 668 |
| TOTAL LIABILITIES | 167,120 | 158,243 |
| Minority interest | 1,162 | 1,137 |
| Shareholders' equity: | | |
| Preferred shares, \$.01 par value, 10,000,000 shares authorized, none issued | - | - |
| Class A Common shares, \$.01 par value, 50,000,000 shares authorized, 6,591,259 and 6,549,950 shares issued, respectively | 66 | 65 |

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| | | |
|--|-------------------|-------------------|
| Class B Common shares, \$.01 par value, 3,000,000 shares authorized, 1,038,871 and 1,080,180 shares issued and outstanding, respectively | 10 | 11 |
| Class C Common shares, \$.01 par value, 4,400,000 shares authorized, 4,150,471 and 4,145,531 shares issued and outstanding, respectively | 42 | 41 |
| Class D Common shares, \$.01 par value, 17,000,000 shares authorized, 11,060,390 and 11,039,803 shares issued and outstanding, respectively | 111 | 110 |
| Capital in excess of par value | 194,337 | 194,696 |
| Accumulated distributions in excess of earnings | (28,643) | (23,749) |
| Cost of treasury shares, 166,694 and 292,238 Class A shares, respectively | (1,213) | (2,124) |
| TOTAL SHAREHOLDERS' EQUITY | 164,710 | 169,050 |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$ 332,992 | \$ 328,430 |

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AmREIT AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

| | Quarter ended June 30, | | Year to date ended June 30, | |
|--|------------------------|---------------|-----------------------------|---------------|
| | 2007 | 2006 | 2007 | 2006 |
| Revenues: | | | | |
| Rental income from operating leases | \$ 7,733 | \$ 7,487 | \$ 14,815 | \$ 13,460 |
| Earned income from direct financing leases | 508 | 508 | 1,015 | 1,015 |
| Real estate fee income | 160 | - | 854 | 751 |
| Real estate fee income - related party | 349 | 910 | 1,062 | 1,677 |
| Construction revenues | 695 | 319 | 792 | 940 |
| Construction revenues - related party | 219 | 2,623 | 1,095 | 3,796 |
| Securities commission income - related party | 1,484 | 1,227 | 2,477 | 2,618 |
| Asset management fee income - related party | 312 | 186 | 596 | 344 |
| Total revenues | 11,460 | 13,260 | 22,706 | 24,601 |
| Expenses: | | | | |
| General and administrative | 1,911 | 2,254 | 4,120 | 4,136 |
| Property expense | 2,037 | 2,162 | 3,767 | 3,184 |
| Construction costs | 868 | 2,609 | 1,729 | 4,284 |
| Legal and professional | 479 | 288 | 774 | 597 |
| Real estate commissions | 26 | - | 447 | 540 |
| Securities commissions | 1,245 | 1,089 | 2,074 | 2,346 |
| Depreciation and amortization | 1,958 | 2,391 | 3,898 | 4,573 |
| Total expenses | 8,524 | 10,793 | 16,809 | 19,660 |
| Operating income | 2,936 | 2,467 | 5,897 | 4,941 |
| Other income (expense): | | | | |
| Interest and other income - related party | 256 | 232 | 500 | 467 |
| (Loss) income from merchant development funds and other affiliates | (15) | 208 | (27) | 306 |
| Federal income tax benefit for taxable REIT subsidiary | 302 | 184 | 501 | 269 |
| Interest expense | (2,351) | (2,090) | (4,708) | (3,833) |
| Minority interest in income of consolidated joint ventures | (27) | (27) | (63) | (58) |
| Income before discontinued operations | 1,101 | 974 | 2,100 | 2,092 |
| Income from discontinued operations, net of taxes | - | 272 | 4 | 241 |
| Gain on sales of real estate acquired for resale, net of taxes | - | 7 | - | 12 |
| Income from discontinued operations | - | 279 | 4 | 253 |
| Net income | 1,101 | 1,253 | 2,104 | 2,345 |
| Distributions paid to class B, C and D shareholders | (2,711) | (2,914) | (5,416) | (5,820) |

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| | | | | | | | | |
|--|----|---------|----|---------|----|---------|----|---------|
| Net loss available to class A shareholders | \$ | (1,610) | \$ | (1,661) | \$ | (3,312) | \$ | (3,475) |
| Net loss per class A common share - basic and diluted | | | | | | | | |
| Loss before discontinued operations | \$ | (0.25) | \$ | (0.30) | \$ | (0.52) | \$ | (0.59) |
| Income from discontinued operations | | - | | 0.04 | | 0.00 | | 0.04 |
| Net loss | \$ | (0.25) | \$ | (0.26) | \$ | (0.52) | \$ | (0.55) |
| Weighted average class A common shares used to compute net loss per share, basic and diluted | | | | | | | | |
| | | 6,411 | | 6,348 | | 6,366 | | 6,339 |

See Notes to Consolidated Financial Statements.

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AmREIT AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
For the six months ended June 30, 2007
(in thousands, except share data)
(unaudited)

| | Common Shares Amount | Capital in excess of par value | Accumulated distributions in excess of earnings | Cost of treasury shares | Total |
|--|----------------------------|--------------------------------------|--|-------------------------------|------------|
| Balance at December 31, 2006 | \$ 227 | \$ 194,696 | \$ (23,749) | \$ (2,124) | \$ 169,050 |
| Net income | - | - | 2,104 | - | 2,104 |
| Deferred compensation issuance of restricted shares, Class A | - | (840) | - | 926 | 86 |
| Issuance of common shares, Class A | 1 | - | - | - | 1 |
| Repurchase of common shares, Class A | - | - | - | (15) | (15) |
| Repurchase of common shares, Class B | (1) | - | - | - | (1) |
| Amortization of deferred compensation | - | 353 | - | - | 353 |
| Issuance of common shares, Class C | 1 | 869 | - | - | 870 |
| Retirement of common shares, Class C | - | (825) | - | - | (825) |
| Issuance of common shares, Class D | 1 | 2,212 | - | - | 2,213 |
| Retirement of common shares, Class D | - | (2,128) | - | - | (2,128) |
| Distributions | - | - | (6,998) | - | (6,998) |
| Balance at June 30, 2007 | \$ 229 | \$ 194,337 | \$ (28,643) | \$ (1,213) | \$ 164,710 |

See Notes to Consolidated Financial Statements.

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AmREIT AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands, except share data)
(unaudited)

| | Year to date ended June 30, | |
|--|-----------------------------------|----------|
| | 2007 | 2006 |
| Cash flows from operating activities: | | |
| Net income | \$ 2,104 | \$ 2,345 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Investment in real estate acquired for resale | - | (623) |
| Proceeds from sales of real estate acquired for resale | 1,399 | 1,153 |
| Loss (gain) on sales of real estate acquired for resale | - | (12) |
| Gain on sales of real estate acquired for investment | - | (286) |
| Loss (income) from merchant development funds and other affiliates | 27 | (306) |
| Depreciation and amortization | 3,865 | 4,463 |
| Amortization of deferred compensation | 353 | 279 |
| Minority interest in income of consolidated joint ventures | 74 | 20 |
| Distributions from merchant development funds and other affiliates | 234 | 29 |
| Decrease (increase) in tenant receivables | 356 | (400) |
| Decrease in accounts receivable | 325 | 225 |
| (Increase) decrease in accounts receivable - related party | (122) | 2,255 |
| Cash receipts from direct financing leases more than income recognized | 23 | 4 |
| (Increase) decrease in other assets | (1,116) | 105 |
| Decrease in accounts payable and other liabilities | (3,856) | (2,168) |
| Increase in security deposits | 11 | 21 |
| Net cash provided by operating activities | 3,677 | 7,104 |
| Cash flows from investing activities: | | |
| Improvements to real estate | (1,602) | (1,523) |
| Acquisition of investment properties | (9,558) | (23,967) |
| Loans to affiliates | (2,444) | (8,415) |
| Payments from affiliates | 5,772 | 5,885 |
| Additions to furniture, fixtures and equipment | (40) | (96) |
| Investment in merchant development funds and other affiliates | (1,001) | - |
| Distributions from merchant development funds and other affiliates | 110 | 64 |
| Proceeds from sale of investment property | - | 4,466 |
| Increase (decrease) in preacquisition costs | 14 | (20) |
| Net cash used in investing activities | (8,749) | (23,606) |
| Cash flows from financing activities: | | |
| Proceeds from notes payable | 59,994 | 52,354 |
| Payments of notes payable | (46,785) | (30,186) |
| Increase in deferred costs | (264) | (199) |
| Purchase of treasury shares | (15) | (1,726) |

| | | |
|--|----------|----------|
| Retirement of common shares | (2,953) | (2,211) |
| Issuance costs | (6) | (43) |
| Common dividends paid | (3,909) | (4,213) |
| Distributions to minority interests | (49) | (49) |
| Net cash provided by financing activities | 6,013 | 13,727 |
| Net increase (decrease) in cash and cash equivalents | 941 | (2,775) |
| Cash and cash equivalents, beginning of period | 3,415 | 5,915 |
| Cash and cash equivalents, end of period | \$ 4,356 | \$ 3,140 |

Supplemental schedule of cash flow information:

Cash paid during the year for:

| | | |
|--------------|----------|----------|
| Interest | \$ 4,728 | \$ 3,815 |
| Income taxes | 341 | 909 |

See Notes to Consolidated Financial Statements.

Supplemental schedule of noncash investing and financing activities

During 2007 and 2006, we converted 41,000 and 49,000 B shares to A shares, respectively. Additionally, during 2007 and 2006, we issued Class C and D shares with a value of \$3.1 million and \$3.2 million, respectively, in satisfaction of dividends through the dividend reinvestment program.

In 2007, we issued 131,000 restricted shares to employees and trust managers as part of their compensation arrangements. The restricted shares vest over a four and three year period, respectively. We recorded \$1.1 million in deferred compensation related to the issuance of the restricted shares.

In 2006, we issued 89,000 restricted shares to employees and trust managers as part of their compensation arrangements. The restricted shares vest over a four and three year period, respectively. We recorded \$571,000 in deferred compensation related to the issuance of the restricted shares.

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AmREIT AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2007
(unaudited)

1. DESCRIPTION OF BUSINESS AND NATURE OF OPERATIONS

We are an established real estate company that, at our core, are value creators who have delivered results to our investors for 22 years. We have elected to be taxed as a real estate investment trust (“REIT”) for federal income tax purposes. Our mission is to build a real estate business with complementary operations that reduce our sensitivity to changing market cycles.

We view ourselves as having two distinct companies in one: *our institutional-grade portfolio of Irreplaceable Corners*—premier retail properties in high-traffic, highly populated areas – which are held for long-term value and provide a foundation to our funds from operations (FFO) growth through a steady stream of rental income; and our *advisory/sponsorship business* that broadens our access to capital and raises equity for a series of merchant development funds, resulting in recurring income from assets under management. We are able to add more of a growth component to the recurring-income nature of each company as well as provide earnings potential from multiple sources with our *real estate development and operating business*, which seeks to provide value through offering an array of services to our tenants and properties, to our advisory/sponsorship business portfolios and to third parties.

When we listed on the AMEX in July 2002, our total assets had a book value of \$48 million and equity under management within our advisory/sponsorship business totaled \$15 million. As of June 30, 2007:

- We owned a real estate portfolio consisting of 50 properties located in 15 states that had a net book value of \$304 million;
- We directly managed, through our five actively managed merchant development funds, a total of \$144 million in contributed capital; and
- We had over 500,000 square feet of retail centers in various stages of development, re-development or in the pipeline for both our advisory/sponsorship business and for third parties.

Our direct predecessor, American Asset Advisers Trust, Inc. (“AAA”), was formed as a Maryland corporation in 1993. Prior to 1998, AAA was externally advised by American Asset Advisors Corp. which was formed in 1985. In June 1998, AAA merged with its advisor and changed its name to AmREIT, Inc. In December 2002, AmREIT, Inc. reorganized as a Texas real estate investment trust and became AmREIT.

Our Class A Common Shares are traded on the American Stock Exchange under the symbol “AMY.” Our offices are located at 8 Greenway Plaza, Suite 1000 Houston, Texas 77046. Our telephone number is 713.850.1400 and we maintain an internet site at www.amreit.com.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

Our financial records are maintained on the accrual basis of accounting whereby revenues are recognized when earned and expenses are recorded when incurred. The consolidated financial statements include our accounts and those of our wholly- or majority-owned subsidiaries in which we have a controlling financial interest. Investments in joint ventures and partnerships where we have the ability to exercise significant influence, but do not exercise control, are accounted for using the equity method. All significant intercompany accounts and transactions have been eliminated in

consolidation.

REVENUE RECOGNITION

We lease space to tenants under agreements with varying terms. The majority of the leases are accounted for as operating leases with revenue being recognized on a straight-line basis over the terms of the individual leases. Accrued rents are included in tenant receivables. Revenue from tenant reimbursements of taxes, maintenance expenses and insurance is recognized in the period the related expense is recorded. Additionally, certain of the lease agreements contain provisions that grant additional rents based on tenants' sales volumes (contingent or percentage rent). Percentage rents are recognized when the tenants achieve the specified targets as defined in their lease agreements. We recognize lease termination fees in the period that the lease is terminated and collection of the fees is reasonably assured. During the six months ended June 30, 2007 and 2006, we recognized lease termination fees of \$153,000 and \$601,000, respectively, which have been included in rental income from operating leases. The terms of certain leases require that the building/improvement portion of the lease be accounted for under the direct financing method which treats the building as if we had sold it to the lessee and entered into a long-term financing arrangement with such lessee. This accounting method is appropriate when the lessee has all of the benefits and risks of property ownership that they otherwise would if they owned the building versus leasing it from us.

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We have been engaged to provide various real estate services, including development, construction, construction management, property management, leasing and brokerage. The fees for these services are recognized as services are provided and are generally calculated as a percentage of revenues earned or to be earned or of property cost, as appropriate. Revenues from fixed-price construction contracts are recognized on the percentage-of-completion method, measured by the physical completion of the structure. Revenues from cost-plus-percentage-fee contracts are recognized on the basis of costs incurred during the period plus the percentage fee earned on those costs. Construction management contracts are recognized only to the extent of the fee revenue.

Construction contract costs include all direct material and labor costs and any indirect costs related to contract performance. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes in job performance, job conditions, and estimated profitability, including those arising from any contract penalty provisions, and final contract settlements may result in revisions to costs and income and are recognized in the period in which the revisions are determined. Any profit incentives are included in revenues when their realization is reasonably assured. An amount equal to contract costs attributable to any claims is included in revenues when realization is probable and the amount can be reliably estimated.

Unbilled construction receivables represent reimbursable costs and amounts earned under contracts in progress as of the date of our balance sheet. Such amounts become billable according to contract terms, which usually consider the passage of time, achievement of certain milestones or completion of the project. Advance billings represent billings to or collections from clients on contracts in advance of revenues earned thereon. Unbilled construction receivables are generally billed and collected within the twelve months following the date of our balance sheet, and advance billings are generally earned within the twelve months following the date of our balance sheet. As of June 30, 2007, \$130,000 of unbilled receivables has been included in "Accounts receivable" and \$92,000 of unbilled receivables due from related parties has been included in "Accounts receivable – related party." As of December 31, 2006, \$126,000 of unbilled receivables has been included in "Accounts receivable" and \$14,000 of unbilled receivables due from related parties has been included in "Accounts receivable – related party." We had advance billings of \$6,000 and \$44,000 as of June 30, 2007 and December 31, 2006, respectively.

Securities commission income is recognized as units of our merchant development funds are sold through our wholly-owned subsidiary, AmREIT Securities Company (ASC). Securities commission income is earned as the services are performed and pursuant to the corresponding prospectus or private offering memorandum. Generally, it includes a selling commission of between 6.5% and 7.5%, a dealer manager fee of between 2.5% and 3.25% and offering and organizational costs of 1.0% to 1.50%. The selling commission is then paid out to the unaffiliated selling broker dealer and reflected as securities commission expense.

REAL ESTATE INVESTMENTS

Development Properties– Land, buildings and improvements are recorded at cost. Expenditures related to the development of real estate are carried at cost which includes capitalized carrying charges, acquisition costs and development costs. Carrying charges, primarily interest, real estate taxes and loan acquisition costs, and direct and indirect development costs related to buildings under construction, are capitalized as part of construction in progress. The capitalization of such costs ceases at the earlier of one year from the date of completion of major construction or when the property, or any completed portion, becomes available for occupancy. We capitalize acquisition costs as incurred. Such costs are expensed if and when the acquisition becomes no longer probable. During the six months ended June 30, 2007 and June 30, 2006 we capitalized \$162,000 and \$53,000, respectively, in interest on properties under development.

Acquired Properties and Acquired Lease Intangibles– We account for real estate acquisitions pursuant to Statement of Financial Accounting Standards No. 141 ("SFAS No. 141"), *Business Combinations*. Accordingly, we allocate the

purchase price of the acquired properties to land, building and improvements, identifiable intangible assets and to the acquired liabilities based on their respective fair values. Identifiable intangibles include amounts allocated to acquired out-of-market leases, the value of in-place leases and customer relationship value, if any. We determine fair value based on estimated cash flow projections that utilize appropriate discount and capitalization rates and available market information. Estimates of future cash flows are based on a number of factors including the historical operating results, known trends and specific market and economic conditions that may affect the property. Factors considered by management in our analysis of determining the as-if-vacant property value include an estimate of carrying costs during the expected lease-up periods considering market conditions, and costs to execute similar leases. In estimating carrying costs, management includes real estate taxes, insurance and estimates of lost rentals at market rates during the expected lease-up periods, tenant demand and other economic conditions. Management also estimates costs to execute similar leases including leasing commissions, tenant improvements, and legal and other related expenses. Intangibles related to out-of-market leases and in-place lease value are recorded as acquired lease intangibles and are amortized as an adjustment to rental revenue or amortization expense, as appropriate, over the remaining terms of the underlying leases. Premiums or discounts on acquired out-of-market debt are amortized to interest expense over the remaining term of such debt.

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Depreciation— Depreciation is computed using the straight-line method over an estimated useful life of up to 50 years for buildings, up to 20 years for site improvements and over the term of lease for tenant improvements. Leasehold estate properties, where we own the building and improvements but not the related ground, are amortized over the life of the lease.

Properties Held for Sale— Properties are classified as held for sale if management has decided to market the property for immediate sale in its present condition with the belief that the sale will be completed within one year. Operating properties held for sale are carried at the lower of cost or fair value less cost to sell. Depreciation and amortization are suspended during the held for sale period. As of June 30, 2007 we owned one property with a carrying value of \$1.8 million that was classified as real estate held for sale. As of December 31, 2006, we did not have any properties that were classified as real estate held for sale.

Our properties generally have operations and cash flows that can be clearly distinguished from the rest of the Company. The operations and gains on sales reported in discontinued operations include those properties that have been sold or are held for sale and for which operations and cash flows have been clearly distinguished. The operations of these properties have been eliminated from ongoing operations, and we will not have continuing involvement after disposition. Prior period operating activity related to such properties has been reclassified as discontinued operations in the accompanying statements of operations.

Impairment— We review our properties for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets, including accrued rental income, may not be recoverable through operations. We determine whether an impairment in value occurred by comparing the estimated future cash flows (undiscounted and without interest charges), including the residual value of the property, with the carrying value of the individual property. If impairment is indicated, a loss will be recorded for the amount by which the carrying value of the asset exceeds its fair value.

RECEIVABLES AND ALLOWANCE FOR UNCOLLECTIBLE ACCOUNTS

Tenant receivables— Included in tenant receivables are base rents, tenant reimbursements and receivables attributable to recording rents on a straight-line basis. An allowance for the uncollectible portion of accrued rents and accounts receivable is determined based upon customer credit-worthiness (including expected recovery of our claim with respect to any tenants in bankruptcy), historical bad debt levels, and current economic trends. As of June 30, 2007 and December 31, 2006, we had an allowance for uncollectible accounts of \$111,000 and \$157,000, respectively, related to our tenant receivables.

Accounts receivable — Included in accounts receivable are amounts due from clients of our construction services business and various other receivables. As of June 30, 2007 and December 31, 2006, we had an allowance for uncollectible accounts of \$264,000 related to our accounts receivable.

Notes receivable – related party— Included in related party notes receivable are loans made to our affiliated merchant development funds as part of our treasury management function whereby we place excess cash in short-term bridge loans for these affiliates related to the acquisition or development of properties. We typically provide such financing to our affiliates as a way of efficiently deploying our excess cash and earning a higher return than we would in other short term investments or overnight funds. In most cases, the merchant development funds have a construction lender in place, and we step in and provide financing on the same terms as the third party lender. In so doing, we are able to access these funds as needed by having our affiliate then draw down on their construction loans. These loans are unsecured, bear interest at the prime rate (8.25% at June 30, 2007) and are due upon demand.

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DEFERRED COSTS

Deferred costs include deferred leasing costs and deferred loan costs, net of amortization. Deferred loan costs are incurred in obtaining property financing and are amortized to interest expense over the term of the debt agreements. Deferred leasing costs consist of internal and external commissions associated with leasing our properties and are amortized to expense over the lease term. Accumulated amortization related to deferred loan costs as of June 30, 2007 and December 31, 2006 totaled \$509,000 and \$421,000, respectively. Accumulated amortization related to deferred leasing costs as of June 30, 2007 and December 31, 2006 totaled \$352,000 and \$264,000, respectively.

DEFERRED COMPENSATION

Our deferred compensation and long term incentive plan is designed to attract and retain the services of our trust managers and employees that we consider essential to our long-term growth and success. As such, it is designed to provide them with the opportunity to own shares, in the form of restricted shares, in us, and provide key employees the opportunity to participate in the success of our affiliated actively managed merchant development funds through the economic participation in our general partner companies. All long term compensation awards are designed to vest over a period of three to seven years and promote retention of our team.

Restricted Share Issuances - Deferred compensation includes grants of restricted shares to our trust managers and employees as a form of long-term compensation. The share grants vest over a period of three to seven years. We determine the fair value of the restricted shares as the number of shares awarded multiplied by the closing price per share of our class A common shares on the grant date. We amortize such fair value ratably over the vesting periods of the respective awards. The following table presents restricted share activity during the six months ended June 30, 2007.

| | Non-vested Shares | Weighted Average grant date fair value |
|---------------------|----------------------|--|
| Beginning of period | 355,599 | 7.31 |
| Granted | 131,334 | 8.51 |
| Vested | (53,090) | 7.34 |
| Forfeited | (14,102) | 7.22 |
| End of period | 419,741 | 7.68 |

The weighted-average grant date fair value of restricted shares issued during the six months ended June 30, 2007 and 2006 was \$8.51 per share and \$7.37 per share, respectively. The total fair value of shares vested during the six months ended June 30, 2007 and 2006 was \$390,000 and \$238,000 respectively. Total compensation cost recognized related to restricted shares during the six months ended June 30, 2007 and 2006 was \$353,000 and \$279,000, respectively. As of June 30, 2007, total unrecognized compensation cost related to restricted shares was \$2.6 million, and the weighted average period over which we expect this cost to be recognized is 4.2 years.

General Partner Profit Participation Interests - We have assigned up to 45% of the economic interest in certain of our merchant development funds to certain of our key employees. This economic interest is received, as, if and when we receive economic benefit from our profit participation, after certain preferred returns have been paid to the partnership's limited partners. This assignment of economic interest generally vests over a period of five to seven

years. This allows us to align the interest of our employees with the interest of our shareholders. Because any future profits and earnings from the merchant development funds cannot be reasonably predicted or estimated, and any employee benefit is contingent upon the benefit received by the general partner of the merchant development funds, we recognize expense associated with the assignment of these economic interests as we recognize the corresponding income from the associated merchant development funds. No portion of the economic interest in the merchant development funds that have provided profit participation to us to date have been assigned to employees. Therefore, no compensation expense has been recorded to date.

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Tax-Deferred Retirement Plan (401k) - We maintain a defined contribution 401k retirement plan for our employees. This plan is available for all employees immediately upon employment. The plan allows for contributions to be either invested in an array of large, mid and small cap mutual funds or directly into class A common shares. Employee contributions invested in our shares are limited to 50% of the employee's contributions. We match 50% of the employee's contribution, up to a maximum employee contribution of 4%. None of the employer contribution can be matched in our shares.

Share Options - We are authorized to grant options of our class A common shares as either incentive or non-qualified share options, up to an aggregate of 6.0% of the total voting shares outstanding. As of June 30, 2007 and December 31, 2006, none of these options have been granted.

INCOME TAXES

We account for federal and state income taxes under the asset and liability method.

Federal - AmREIT has elected to be taxed as a REIT under the Internal Revenue Code of 1986, and is, therefore, not subject to Federal income taxes to the extent of dividends paid, provided it meets all conditions specified by the Internal Revenue Code for retaining its REIT status, including the requirement that at least 90% of its real estate investment trust taxable income be distributed to shareholders.

AmREIT's real estate development and operating business, AmREIT Realty Investment Corporation and subsidiaries ("ARIC"), is a fully integrated and wholly-owned business consisting of brokers and real estate professionals that provide development, acquisition, brokerage, leasing, construction, asset and property management services to our publicly traded portfolio and merchant development funds as well as to third parties. ARIC and our wholly-owned corporations that serve as the general partners of our merchant development funds are treated for Federal income tax purposes as taxable REIT subsidiaries (collectively, the "Taxable REIT Subsidiaries").

State- In May 2006, the State of Texas adopted House Bill 3, which modified the state's franchise tax structure, replacing the previous tax based on capital or earned surplus with one based on margin (often referred to as the "Texas Margin Tax") effective with franchise tax reports filed on or after January 1, 2008. The Texas Margin Tax is computed by applying the applicable tax rate (1% for us) to the profit margin, which, generally, will be determined for us as total revenue less a 30% standard deduction. Although House Bill 3 states that the Texas Margin Tax is not an income tax, SFAS No. 109, *Accounting for Income Taxes*, applies to the Texas Margin Tax. We have recorded a margin tax provision of \$124,000 for the Texas Margin Tax for the six months ended June 30, 2007.

EARNINGS PER SHARE

Basic earnings per share has been computed by dividing net loss available to class A common shareholders by the weighted average number of class A common shares outstanding. Diluted earnings per share has been computed by dividing net income (as adjusted as appropriate) by the weighted average number of common shares outstanding plus the weighted average number of dilutive potential common shares. Diluted earnings per share information is not applicable due to the anti-dilutive nature of the common class B, class C and class D shares which represent 20.4 million and 25.8 million potential common shares for the six months ended June 30, 2007 and 2006, respectively.

The following table presents information necessary to calculate basic and diluted earnings per class A share for the six and nine months ended June 30, as indicated:

| | |
|---------|-----|
| Quarter | YTD |
|---------|-----|

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| | 2007 | 2006 | 2007 | 2006 |
|---|------------|---------|---------|---------|
| Loss to class A common shareholders* | \$ (1,610) | (1,661) | (3,312) | (3,475) |
| Weighted average class A common shares outstanding* | 6,411 | 6,348 | 6,366 | 6,339 |
| Basic and diluted loss per share | (0.25) | (0.26) | (0.52) | (0.55) |

* In thousands

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USE OF ESTIMATES

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

FAIR VALUE OF FINANCIAL INSTRUMENTS

Our consolidated financial instruments consist primarily of cash, cash equivalents, tenant receivables, accounts receivable, notes receivable, accounts payable and other liabilities and notes payable. The carrying value of cash, cash equivalents, tenant receivables, accounts receivable, notes receivable, accounts payable and other liabilities are representative of their respective fair values due to the short-term maturity of these instruments. Our revolving line of credit has market-based terms, including a variable interest rate. Accordingly, the carrying value of the line of credit is representative of its fair value.

As of June 30, 2007, the carrying value of our total debt obligations was \$157.5 million, \$151.7 million of which represented fixed rate obligations and had an estimated fair value of \$149.3 million. As of December 31, 2006, the carrying value of our total debt obligations was \$144.5 million, \$132.5 million of which represented fixed-rate obligations with an estimated fair value of \$132.9 million.

CONSOLIDATION OF VARIABLE INTEREST ENTITIES

In December 2003, the FASB reissued Interpretation No. 46 (“FIN 46R”), *Consolidation of Variable Interest Entities*, as revised. FIN 46R addresses how a business enterprise should evaluate whether it has a controlling financial interest in an entity through means other than voting rights. FIN 46R requires a variable interest entity to be consolidated by a company that is subject to a majority of the risk of loss from the variable interest entity’s activities or entitled to receive a majority of the entity’s residual returns or both. Disclosures are also required about variable interest entities in which a company has a significant variable interest but that it is not required to consolidate.

As of June 30, 2007, we are an investor in and the primary beneficiary of one entity that qualifies as a variable interest entity pursuant to FIN 46R. This entity was established to develop, own, manage, and hold property for investment and comprises \$4.2 million of our total consolidated assets at period end. This entity had no debt outstanding at period end.

NEW ACCOUNTING STANDARDS

In June 2006, the Financial Accounting Standards Board (“FASB”) issued FASB Interpretation No. 48 (“FIN 48”), *Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in the financial statements. The interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition of a tax position taken, or expected to be taken, in a tax return. A tax position may only be recognized in the financial statements if it is more likely than not that the tax position will be sustained upon examination. There are also several disclosure requirements. We adopted this interpretation during the first quarter of 2007, and it had no effect on our consolidated financial statements.

In September 2006, the FASB issued “SFAS No.157,” *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value and requires enhanced disclosures about fair value measurements. SFAS No. 157 requires companies to disclose the fair value of its financial instruments according to a

fair value hierarchy. Additionally, companies are required to provide certain disclosures regarding instruments within the hierarchy, including a reconciliation of the beginning and ending balances for each major category of assets and liabilities. SFAS No. 157 is effective for our fiscal year beginning January 1, 2008. The adoption of SFAS No. 157 is not expected to have a material effect on our results of operations or financial position.

In February 2007 the FASB issued “SFAS No. 159,” *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS No. 159 expands opportunities to use fair value measurement in financial reporting and permits entities to choose to measure many financial instruments and certain other items at fair value. This Statement is effective for fiscal years beginning after November 15, 2007. We have not yet decided if we will choose to measure any eligible financial assets and liabilities at fair value under the provisions of SFAS No. 159.

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DISCONTINUED OPERATIONS

The following is a summary of our discontinued operations (in thousands, except for per share data):

| | Quarter | | YTD | |
|--|---------|---------|-------|---------|
| | 2007 | 2006 | 2007 | 2006 |
| Rental revenue and earned income from DFL | \$ 44 | \$ 24 | \$ 68 | \$ 52 |
| Gain on sale of real estate held for investment | - | 293 | - | 286 |
| Gain on sale of real estate held for resale | - | 7 | - | 12 |
| Total revenues | 44 | 324 | 68 | 350 |
| Property expense | (7) | (112) | - | (114) |
| Other general and administrative | (6) | 16 | (6) | 1 |
| Federal income tax expense | (2) | 15 | (4) | 13 |
| Legal and professional | (3) | (2) | (5) | (13) |
| Depreciation and amortization | (11) | (6) | (14) | (16) |
| Minority interest | (6) | 44 | (12) | 39 |
| Interest expense | (9) | - | (23) | (7) |
| Total expenses | (44) | (45) | (64) | (97) |
| Income from discontinued operations | - | 279 | 4 | 253 |
| Basic and diluted income from discontinued operations per class A common share | \$ - | \$ 0.04 | \$ - | \$ 0.04 |

STOCK ISSUANCE COSTS

Issuance costs incurred in the raising of capital through the sale of common shares are treated as a reduction of shareholders' equity.

CASH AND CASH EQUIVALENTS

For purposes of the consolidated statements of cash flows, we consider all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. Cash and cash equivalents consist of demand deposits at commercial banks and money market funds.

RECLASSIFICATIONS

Certain amounts in the prior period consolidated financial statements have been reclassified to conform to the presentation used in the current period consolidated financial statements. Such reclassifications had no effect on net income (loss) or shareholders' equity as previously reported.

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3. INVESTMENTS IN MERCHANT DEVELOPMENT FUNDS

AAA CTL Notes, Ltd.

AAA CTL Notes I Corporation (“AAA Corp”), our wholly-owned subsidiary, invested as a general partner and limited partner in AAA CTL Notes, Ltd. (“AAA”). AAA is a majority-owned subsidiary through which we purchased 15 IHOP leasehold estate properties and two IHOP fee simple properties. We have consolidated AAA in our financial statements. Certain members of our management team have been assigned a 51% aggregate interest in the income and cash flow of AAA’s general partner. Net sales proceeds from the liquidation of AAA will be allocated to the limited partners and to the general partner pursuant to the AAA limited partnership agreement.

Merchant Development Funds

As of June 30, 2007, we owned, through wholly-owned subsidiaries, interests in six limited partnerships which are accounted for under the equity method as we exercise significant influence over, but do not control, the investee. In each of the partnerships, the limited partners have the right, with or without cause, to remove and replace the general partner by a vote of the limited partners owning a majority of the outstanding units. These merchant development funds were formed to develop, own, manage and add value to properties with an average holding period of two to four years. Our interests in these merchant development funds range from 2.1% to 10.5%. See Note 8 regarding transactions we have entered into with our merchant development funds.

AmREIT Opportunity Fund (“AOF”)— AmREIT Opportunity Corporation (“AOC”), our wholly-owned subsidiary of AmREIT, invested \$250,000 as a limited partner and \$1,000 as a general partner in AOF. We currently own a 10.5% limited partner interest in AOF. Liquidation of AOF commenced in July of 2002, and, as of June 30, 2007, AOF has an interest in one property. As the general partner, AOC receives a promoted interest in cash flow and any profits after certain preferred returns are achieved for its limited partners.

AmREIT