

INCOME OPPORTUNITY REALTY INVESTORS INC /TX/
Form 10-Q
November 12, 2014

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

FORM 10-Q

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

For the quarterly period ended September 30, 2014

or

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

For the transition period from _____ to _____

Commission File Number 001-14784

INCOME OPPORTUNITY REALTY INVESTORS, INC.
(Exact Name of Registrant as Specified in Its Charter)

Nevada
(State or Other Jurisdiction of
Incorporation or Organization)

75-2615944
(I.R.S. Employer
Identification No.)

1603 Lyndon B. Johnson Freeway, Suite 800, Dallas, Texas 75234
(Address of principal executive offices)
(Zip Code)

(469) 522-4200

(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 No

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer

Non-accelerated filer (Do not check if smaller reporting company) Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date.

Common Stock, \$.01 par value
(Class)

4,168,214
(Outstanding at November 5, 2014)

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

INCOME OPPORTUNITY REALTY INVESTORS, INC.
CONSOLIDATED BALANCE SHEETS
(unaudited)

	September 30, 2014	December 31, 2013
	(dollars in thousands, except par value amount)	
Assets		
Real estate land holdings, at cost	\$24,515	\$24,511
Total real estate	24,515	24,511
Notes and interest receivable from related parties	26,691	30,693
Less allowance for doubtful accounts	(1,826)	(1,826)
Total notes and interest receivable	24,865	28,867
Cash and cash equivalents	3	3
Receivable and accrued interest from related parties	42,753	39,207
Other assets	1,260	1,225
Total assets	\$93,396	\$93,813
Liabilities and Shareholders' Equity		
Liabilities:		
Notes and interest payable - related parties	\$10,240	\$12,357
Accounts payable and other liabilities	39	216
Total liabilities	10,279	12,573
Shareholders' equity:		
Common stock, \$0.01 par value, authorized 10,000,000. issued 4,173,675 and outstanding 4,168,214 shares in 2014 and 2013	42	42
Treasury stock at cost, 5,461 shares in 2014 and 2013	(39)	(39)
Paid-in capital	61,955	61,955
Retained earnings	21,159	19,282
Total shareholders' equity	83,117	81,240
Total liabilities and shareholders' equity	\$93,396	\$93,813

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

INCOME OPPORTUNITY REALTY INVESTORS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
	(dollars in thousands, except per share amounts)			
Revenues:				
Rental and other property revenues	\$-	\$-	\$-	\$-
Expenses:				
Property operating expenses (including \$13 and \$13 for the three months and \$37 and \$36 for the nine months ended 2014 and 2013, respectively, from related parties)	13	49	42	72
General and administrative (including \$61 and \$60 for the three months and \$181 and \$178 for the nine months ended 2014 and 2013, respectively, from related parties)	143	192	422	536
Net income fee to related party	51	55	152	159
Advisory fee to related party	173	209	516	621
Total operating expenses	380	505	1,132	1,388
Net operating loss	(380)	(505)	(1,132)	(1,388)
Other income (expenses):				
Interest income from related parties	1,179	1,427	3,547	4,251
Mortgage and loan interest	(176)	(297)	(538)	(879)
Total other income	1,003	1,130	3,009	3,372
Net income from continuing operations before tax	623	625	1,877	1,984
Income tax expense	-	-	-	(6)
Net income from continuing operations	623	625	1,877	1,978
Discontinued operations:				
Net loss from discontinued operations	-	-	-	(18)
Gain (loss) on the sale of real estate from discontinued operations	-	-	-	-
Income tax benefit from discontinued operations	-	-	-	6
Net loss from discontinued operations	-	-	-	(12)
Net income	\$623	\$625	\$1,877	\$1,966
Earnings per share - basic				
Net income from continuing operations	\$0.15	\$0.15	\$0.45	\$0.47
Net income from discontinued operations	-	-	-	-
Net income applicable to common shares	\$0.15	\$0.15	\$0.45	\$0.47
Earnings per share - diluted				
Net income from continuing operations	\$0.15	\$0.15	\$0.45	\$0.47
Net income from discontinued operations	-	-	-	-
Net income applicable to common shares	\$0.15	\$0.15	\$0.45	\$0.47

Weighted average common shares used in computing earnings per share	4,168,214	4,168,214	4,168,214	4,168,214
Weighted average common shares used in computing diluted earnings per share	4,168,214	4,168,214	4,168,214	4,168,214

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

INCOME OPPORTUNITY REALTY INVESTORS, INC.
 CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
 For the Nine Months Ended September 30, 2014
 (unaudited, dollars in thousands)

	Total	Common Stock Shares	Common Stock Amount	Treasury Stock	Paid-in Capital	Retained Earnings
Balance, December 31, 2013	\$81,240	4,173,675	\$42	\$(39)	\$61,955	\$19,282
Net income	1,877	-	-	-	-	1,877
Balance, September 30, 2014	\$83,117	4,173,675	\$42	\$(39)	\$61,955	\$21,159

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

INCOME OPPORTUNITY REALTY INVESTORS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	For the Nine Months Ended September 30, 2014 2013 (dollars in thousands)	
Cash Flow From Operating Activities:		
Net income	\$1,877	\$1,966
Adjustments to reconcile net income applicable to common shares to net cash flows from operating activities:		
Decrease (increase) in assets:		
Accrued interest receivable from related parties	4,002	(1,386)
Other assets	(35)	(943)
Decrease in liabilities:		
Accrued interest payable to related parties	-	(158)
Other liabilities	(177)	(40)
Net cash provided by (used in) operating activities	5,667	(561)
Cash Flow From Investing Activities:		
Real estate improvements	(4)	-
Related party receivables	(3,546)	562
Net cash provided by (used in) investing activities	(3,550)	562
Cash Flow From Financing Activities:		
Payments on notes payable to related parties	(2,117)	-
Net cash used in financing activities	(2,117)	-
Net increase in cash and cash equivalents	-	1
Cash and cash equivalents, beginning of period	3	2
Cash and cash equivalents, end of period	\$3	\$3
Supplemental disclosures of cash flow information:		
Cash paid for interest	\$519	\$879

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. ORGANIZATION AND BASIS OF PRESENTATION

Organization

As used herein, the terms “IOT”, “the Company”, “we”, “our”, “us” refer to Income Opportunity Realty Investors, Inc., a Nevada corporation, individually or together with its subsidiaries. Income Opportunity Realty Investors, Inc. is the successor to a California business trust organized on December 14, 1984, which commenced operations on April 10, 1985. The Company is headquartered in Dallas, Texas, and its common stock trades on the NYSE MKT under the symbol (“IOT”).

Transcontinental Realty Investors, Inc. (“TCI”) owns approximately 81.1% of the Company’s common stock. Effective July 17, 2009, IOT’s financial results were consolidated with those of American Realty Investors, Inc. (“ARL”) and TCI and their subsidiaries. IOT is a “C” corporation for U.S. federal income tax purposes and files an annual consolidated income tax return with ARL and its ultimate parent, May Realty Holdings, Inc., formerly known as Realty Advisors Management, Inc. We have no employees.

IOT invests in real estate through direct ownership, leases and partnerships and also invests in mortgage loans on real estate. Pillar Income Asset Management, Inc. (“Pillar”) is the Company’s external Advisor and Cash Manager. Although the Board of Directors is directly responsible for managing the affairs of IOT, and for setting the policies which guide it, the day-to-day operations of IOT are performed by Pillar, as the contractual Advisor, under the supervision of the Board. Pillar’s duties include, but are not limited to, locating, evaluating and recommending real estate and real estate-related investment opportunities and arranging debt and equity financing for the Company with third party lenders and investors. Additionally, Pillar serves as a consultant to the Board with regard to their decisions in connection with IOT’s business plan and investment policy. Pillar also serves as an Advisor and Cash Manager to TCI and ARL.

Our primary business is investing in real estate and mortgage receivables. Land held for development or sale is our sole operating segment. At September 30, 2014, our land consisted of 178.1 acres of land held for future development or sale. All of our land holdings are located in Farmers Branch, Texas. The principal source of revenue for the Company is interest income on over \$25.4 million of note receivables due from related parties.

Basis of Presentation

The accompanying unaudited Consolidated Financial Statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States, or GAAP, have been condensed or omitted in accordance with such rules and regulations, although management believes the disclosures are adequate to prevent the information presented from being misleading. In the opinion of management, all adjustments (consisting of normal recurring matters) considered necessary for a fair presentation have been included. The results of operations for the nine months ended September 30, 2014, are not necessarily indicative of the results that may be expected for other interim periods or for the full fiscal year.

The year-end Consolidated Balance Sheet at December 31, 2013, was derived from the audited financial statements at that date, but does not include all of the information and disclosures required by GAAP for complete financial statements. For further information, refer to the financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2013. Certain 2013 financial statement amounts have been reclassified to conform to the 2014 presentation, including adjustments for discontinued operations.

Principles of Consolidation

The accompanying Consolidated Financial Statements include our accounts, our subsidiaries, generally all of which are wholly-owned, and all entities in which we have a controlling interest. Arrangements that are not controlled through voting or similar rights are accounted for as a Variable Interest Entity (“VIE”), in accordance with the provisions and guidance of ASC Topic 810 “Consolidation”, whereby we have determined that we are a primary beneficiary of the VIE and meet certain criteria of a sole general partner or managing member as identified in accordance with Emerging Issues Task Force (“EITF”) Issue 04-5, Investor’s Accounting for an Investment in a Limited Partnership when the Investor is the Sole General Partner and the Limited Partners have Certain Rights (“EITF 04-5”). VIEs are generally entities that lack sufficient equity to finance their activities without additional financial support from other parties or whose equity holders as a group lack adequate decision making ability, the obligation to absorb expected losses or residual returns of the entity, or have voting rights that are not proportional to their economic interests. The primary beneficiary generally is the entity that provides financial support and bears a majority of the financial risks, authorizes certain capital transactions, or makes operating decisions that materially affect the entity’s financial results. All significant intercompany balances and transactions have been eliminated in consolidation.

In determining whether we are the primary beneficiary of a VIE, we consider qualitative and quantitative factors, including, but not limited to: the amount and characteristics of our investment; the obligation or likelihood for us or other investors to provide financial support; our and the other investors' ability to control or significantly influence key decisions for the VIE; and the similarity with and significance to the business activities of us and the other investors. Significant judgments related to these determinations include estimates about the current future fair values and performance of real estate held by these VIEs and general market conditions. As of September 30, 2014, IOT was not the primary beneficiary of a VIE.

For entities in which we have less than a controlling financial interest or entities where we are not deemed to be the primary beneficiary, the entities are accounted for using the equity method of accounting. Accordingly, our share of the net earnings or losses of these entities is included in net income. Our investment in TCI Eton Square, LP was accounted for under the equity method. As of April 8, 2013 the underlying asset owned by this entity was transferred to the existing lender in a settlement agreement and IOT no longer recorded on its books, an investment in this entity. The investment was previously written down to a zero basis and at the date of the transfer IOT recorded no gain or loss on the transfer.

Real Estate, Depreciation and Impairment

Real estate assets are stated at the lower of depreciated cost or fair value, if deemed impaired. Major replacements and betterments are capitalized and depreciated over their estimated useful lives. Depreciation is computed on a straight-line basis over the useful lives of the properties (buildings and improvements – 10-40 years; furniture, fixtures and equipment – 5-10 years). The Company continually evaluates the recoverability of the carrying value of our real estate assets using the methodology prescribed in ASC Topic 360, "Property, Plant and Equipment". Factors considered by management in evaluating impairment of our existing real estate assets held for investment include significant declines in property operating profits, annually recurring property operating losses and other significant adverse changes in general market conditions that are considered permanent in nature. Under ASC Topic 360, a real estate asset held for investment is not considered impaired if the undiscounted, estimated future cash flows of an asset (both the annual estimated cash flow from future operations and the estimated cash flow from the theoretical sale of the asset) over its estimated holding period are in excess of the asset's net book value at the balance sheet date. If any real estate asset held for investment is considered impaired, a loss is provided to reduce the carrying value of the asset to its estimated fair value.

Real Estate Held For Sale

We periodically classify real estate assets as "held for sale". An asset is classified as held for sale after the approval of our Board of Directors, after an active program to sell the asset has commenced and if the sale is probable. One of the deciding factors in determining whether a sale is probable is whether the firm purchase commitment is obtained and whether the sale is probable within the year. Upon the classification of a real estate asset as held for sale, the carrying value of the asset is reduced to the lower of its net book value or its estimated fair value, less costs to sell the asset. Subsequent to the classification of assets as held for sale, no further depreciation expense is recorded. Real estate assets held for sale are stated separately on the accompanying Consolidated Balance Sheets. Upon a decision that the sale is no longer probable, the asset is classified as an operating asset and depreciation expense is reinstated. The operating results of real estate assets held for sale and sold are reported as discontinued operations in the accompanying Consolidated Statements of Operations. Income from discontinued operations includes the revenues and expenses, including depreciation and interest expense, associated with the assets. This classification of operating results as discontinued operations applies retroactively for all periods presented. Additionally, gains and losses on assets designated as held for sale are classified as part of discontinued operations.

Cost Capitalization

Costs related to planning, developing, leasing and constructing a property are capitalized and classified as Real Estate in the Consolidated Balance Sheets. We capitalize interest to qualifying assets under development based on average accumulated expenditures outstanding during the period. In capitalizing interest to qualifying assets, we first use the interest incurred on specific project debt, if any, and next use the weighted average interest rate of non-project specific debt.

We capitalize interest, real estate taxes and certain operating expenses until building construction is substantially complete and the building is ready for its intended use, but no later than one year from the cessation of major construction activity.

We capitalize leasing costs which include commissions paid to outside brokers, legal costs incurred to negotiate and document a lease agreement and any internal costs that may be applicable. We allocate these costs to individual tenant leases and amortize them over the related lease term.

Fair Value Measurement

We apply the guidance in ASC Topic 820, “Fair Value Measurements and Disclosures”, to the valuation of real estate assets. These provisions define fair value as the price that would be received to sell an asset or paid to transfer a liability in a transaction between market participants at the measurement date, establish a hierarchy that prioritizes the information used in developing fair value estimates and require disclosure of fair value measurements by level within the fair value hierarchy. The hierarchy gives the highest priority to quoted prices in active markets (Level 1 measurements) and the lowest priority to unobservable data (Level 3 measurements), such as the reporting entity’s own data.

The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date and includes three levels defined as follows:

Level 1 –Unadjusted quoted prices for identical and unrestricted assets or liabilities in active markets.

Level 2 –Quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 –Unobservable inputs that are significant to the fair value measurement.

A financial instrument’s categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Related Parties

We apply ASC Topic 805, “Business Combinations”, to evaluate business relationships. Related parties are persons or entities who have one or more of the following characteristics, which include entities for which investments in their equity securities would be required, trust for the benefit of persons including principal owners of the entities and members of their immediate families, management personnel of the entity and members of their immediate families and other parties with which the entity may deal if one party controls or can significantly influence the decision making of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests, or affiliates of the entity.

Newly Issued Accounting Pronouncements

We have considered all other newly issued accounting guidance that is applicable to our operations and the preparation of our Consolidated Financial Statements, including that which we have not yet adopted. We do not believe that any such guidance will have a material effect on our financial position or results of operations.

NOTE 2. REAL ESTATE ACTIVITY

On September 30, 2014, our portfolio consisted of 178.1 contiguous acres of land held for development or sale. The table below shows information relating to the land owned:

Land	Location	Acres
Mercer Crossing/Travelers Land	Farmers Branch, TX	178.10
	Total Land/Development	178.10

NOTE 3. NOTES AND INTEREST RECEIVABLE FROM RELATED PARTIES

Junior Mortgage Loans. Junior mortgage loans are loans secured by mortgages that are subordinate to one or more prior liens on the underlying real estate. Recourse on the loans ordinarily includes the real estate which secures the loan, other collateral and personal guarantees of the borrower.

At September 30, 2014, we had junior mortgage loans and accrued interest receivable from related parties, net of allowances, totaling \$24.9 million. The loans mature in December 2032 and have interest rates at 12.0%. As of September 30, 2014, we recognized interest income of \$2.3 million related to these notes receivable.

Payments are due from surplus cash flow or sale or refinancing of the underlying properties. These notes are cross collateralized to the extent that any surplus cash available from the sale or refinance of any of the properties underlying these notes will be used to repay outstanding interest and principal for the remaining notes. The allowance on the notes was a purchase allowance that was netted against the notes when acquired. Our mortgage notes receivable consist of junior mortgage loans (dollars in thousands):

Borrower	Maturity Date	Interest Rate	Amount	Security
Performing loans:				
Unified Housing Foundation, Inc. (Echo Station)	12/32	12.00%	\$ 1,481	100% Membership Interest in Unified Housing of Temple, LLC
Unified Housing Foundation, Inc. (Lakeshore Villas)	12/32	12.00%	2,000	Secured
Unified Housing Foundation, Inc. (Lakeshore Villas)	12/32	12.00%	6,363	Membership Interest in Housing for Seniors of Humble, LLC
Unified Housing Foundation, Inc. (Limestone Canyon)	12/32	12.00%	3,057	100% Membership Interest in Unified Housing of Austin, LLC
Unified Housing Foundation, Inc. (Limestone Ranch)	12/32	12.00%	2,250	100% Membership Interest in Unified Housing of Vista Ridge, LLC
Unified Housing Foundation, Inc. (Parkside Crossing)	12/32	12.00%	1,936	100% Membership Interest in Unified Housing of Parkside Crossing, LLC
Unified Housing Foundation, Inc. (Sendero Ridge)	12/32	12.00%	5,174	100% Membership Interest in Unified Housing of Sendero Ridge, LLC
Unified Housing Foundation, Inc. (Timbers of Terrell)	12/32	12.00%	1,323	100% Membership Interest in Unified Housing of Terrell, LLC
Unified Housing Foundation, Inc. (Tivoli)	12/32	12.00%	1,826	100% Membership Interest in Unified Housing of Tivoli, LLC
Accrued interest			1,281	
Total Performing			\$ 26,691	
Allowance for doubtful accounts			(1,826)	
Total			\$ 24,865	

All are related party notes.

The Company has various notes receivable from Unified Housing Foundation, Inc. ("UHF"). UHF is determined to be a related party to the Company due to our significant investment in the performance of the collateral secured under the notes receivable.

NOTE 4. NOTES AND INTEREST PAYABLE

The following table lists the mortgage notes payable as of September 30, 2014 (dollars in thousands):

Lender	Maturity	Principal Balance
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Realty Advisors, Inc - related party *	12/30/16	\$	10,236
Propel Financial Services	06/01/20		4
Accrued interest			-
		\$	10,240

*On December 31, 2013, Realty Advisors, Inc. (“RAI”), a related party, obtained a \$20 million mortgage on the Company’s behalf, secured by Mercer/Travelers land owned by the Company and 100.05 acres of land owned by its parent TCI. The Company and TCI have executed a promissory note to RAI for the same terms as the First NBC loan with a maturity of December 30, 2016, and a variable interest rate of prime plus 1.5% with an interest rate floor of 6%. On May 28, 2014, a \$1.5 million principal payment was made and two additional land parcels, including 8.0 acres of Ladue land owned by TCI and 16.75 acres of Valwood land owned by ARL, were substituted as collateral under the note in exchange for a release of a \$4 million deposit account. The principal balance is allocated based on the land valuation.

There is a property tax loan in the amount of \$3,826 that accrues interest at 12.50% and matures on June 1, 2020.

NOTE 5. RECEIVABLE FROM AND PAYABLE TO RELATED PARTIES

From time to time, IOT and its related parties have made unsecured advances to each other which include transactions involving the purchase, sale, and financing of property. In addition, we have a cash management agreement with our Advisor. The agreement provides for excess cash to be invested in and managed by our Advisor, Pillar, a related party. The table below reflects the various transactions between IOT, Pillar, and TCI (dollars in thousands):

	TCI	Pillar	Total
Balance, December 31, 2013	\$39,207	\$-	\$39,207
Cash transfers	-	5,890	5,890
Advisory fees	-	(516)	(516)
Net income fee	-	(152)	(152)
Cost reimbursements	-	(181)	(181)
Expenses paid by advisor	-	(4)	(4)
Financing (mortgage payments)	-	(2,772)	(2,772)
Interest income	1,281	-	1,281
Purchase of obligation	2,265	(2,265)	-
Balance, September 30, 2014	\$42,753	\$-	\$42,753