

TRANSCONTINENTAL REALTY INVESTORS INC  
Form 10-Q  
August 14, 2006  
Table of Contents

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**FORM 10-Q**

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

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**x QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT  
OF 1934  
FOR THE QUARTER ENDED JUNE 30, 2006**

Or

**.. TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934  
FOR THE TRANSITION PERIOD FROM TO**

**Commission File Number 001-09240**

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**TRANSCONTINENTAL REALTY INVESTORS, INC.**

**(Exact Name of Registrant as Specified in Its Charter)**

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**Nevada  
(State or Other Jurisdiction of  
Incorporation or Organization)**

**1800 Valley View Lane, Suite 300**

**Dallas, Texas 75234**

**95-6565852  
(I.R.S. Employer**

**Identification No.)**

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(Address of principal executive offices) (Zip Code)

(469) 522-4200

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes  No

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

**Large accelerated filer**

**Accelerated filer**

**Non-accelerated filer**

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

**APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE**

**PRECEDING FIVE YEARS:**

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes  No

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

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)

**7,900,869**  
(Outstanding at June 30, 2006)

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**Table of Contents**

**TRANSCONTINENTAL REALTY INVESTORS, INC.**

**FORM 10-Q**

**TABLE OF CONTENTS**

|  | <b>PAGE</b> |
|--|-------------|
| <b><u>PART I: FINANCIAL INFORMATION</u></b>  |             |
| Item 1. <u>Financial Statements</u>  |             |
| <u>Consolidated Balance Sheets at June 30, 2006 (Unaudited) and December 31, 2005</u>                              | 3           |
| <u>Consolidated Statements of Operations for the three and six months ended June 30, 2006 and 2005 (Unaudited)</u> | 4           |
| <u>Consolidated Statement of Stockholders' Equity for the six months ended June 30, 2006 (Unaudited)</u>           | 6           |
| <u>Consolidated Statements of Cash Flows for the six months ended June 30, 2006 and 2005 (Unaudited)</u>           | 7           |
| <u>Notes to Consolidated Financial Statements</u>  | 9           |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>               | 22          |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>  | 28          |
| Item 4. <u>Controls and Procedures</u>   | 28          |
| <b><u>PART II. OTHER INFORMATION</u></b>   |             |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>   | 29          |
| Item 6. <u>Exhibits</u>  | 30          |
| <u>SIGNATURE PAGES</u>   | 31          |

**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****TRANSCONTINENTAL REALTY INVESTORS, INC.****CONSOLIDATED BALANCE SHEETS**

(dollars in thousands, except share data)

|  | June 30,<br>2006<br>(Unaudited) | December 31,<br>2005 |
|--|---------------------------------|----------------------|
| <b>Assets</b>  |                                 |                      |
| Real estate held for investment  | \$ 986,793                      | \$ 911,981           |
| Less accumulated depreciation  | (87,921)                        | (78,096)             |
|  | 898,872                         | 833,885              |
| Real estate held-for-sale  | 35,347                          | 40,446               |
| Real estate subject to sales contract  | 66,827                          | 68,738               |
| Notes and interest receivable  |                                 |                      |
| Performing (including \$21,991 in 2006 and \$34,370 in 2005 from affiliates and related parties)   | 37,793                          | 59,922               |
| Non-performing, non-accruing   | 4,893                           | 4,896                |
|  | 42,686                          | 64,818               |
| Investment in real estate entities   | 24,591                          | 24,659               |
| Marketable equity securities, at market value  | 8,309                           | 7,446                |
| Cash and cash equivalents  | 11,811                          | 5,462                |
| Other assets (including \$1,010 in 2006 and \$1,103 in 2005 from affiliates and related parties)   | 40,247                          | 43,625               |
|  | \$ 1,128,690                    | \$ 1,089,079         |
| <b>Liabilities and Stockholders Equity</b>   |                                 |                      |
| <b>Liabilities:</b>  |                                 |                      |
| Notes payable (including \$6,769 in 2006 and \$6,787 in 2005 to affiliates and related parties)  | \$ 694,549                      | \$ 654,882           |
| Interest payable (including \$550 in 2006 and \$218 in 2005 to affiliates and related parties)   | 2,624                           | 3,510                |
| Liabilities related to assets held-for-sale  | 53,084                          | 53,084               |
| Liabilities related to assets subject to sales contract  | 58,347                          | 58,685               |
| Other liabilities (including \$16,867 in 2006 and \$12,272 in 2005 to affiliates and related parties)  | 56,011                          | 66,500               |
|  | 864,615                         | 836,661              |
| Commitments and contingencies  |                                 |                      |
| Minority interest  | 16,174                          | 1,239                |
| <b>Stockholders equity:</b>  |                                 |                      |
| <b>Preferred Stock</b>   |                                 |                      |
| Series C Cumulative Convertible; \$.01 par value; authorized, issued and outstanding 30,000 shares; (liquidation preference \$3,000)         |                                 |                      |
| Common Stock, \$.01 par value; authorized, 10,000,000 shares; issued and outstanding 7,900,869 shares at June 30, 2006 and December 31, 2005 | 81                              | 81                   |

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|   |              |              |
|---|--------------|--------------|
| Additional paid-in capital                    | 256,389      | 256,494      |
| Treasury stock, at cost                       | (3,086)      | (3,086)      |
| Accumulated deficit                           | (5,688)      | (1,846)      |
| Accumulated other comprehensive income (loss) | 205          | (464)        |
|   | 247,901      | 251,179      |
|   | \$ 1,128,690 | \$ 1,089,079 |

The accompanying notes are an integral part of these Consolidated Financial Statements.

**Table of Contents****TRANSCONTINENTAL REALTY INVESTORS, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)**

|  | For the Three Months Ended               |           | For the Six Months Ended |           |
|--|--|-----------|--------------------------|-----------|
|  | June 30,<br>2006                         | 2005      | June 30,<br>2006         | 2005      |
|  | (dollars in thousands, except per share) |           |                          |           |
| Property revenue:  |  |           |                          |           |
| Rents and other property revenues  | \$ 30,822                                | \$ 24,834 | \$ 61,125                | \$ 47,431 |
| Expenses:  |  |           |                          |           |
| Property operations (including \$3,039 in 2006 and \$5,408 in 2005 to affiliates and related parties)        | 18,473                                   | 15,573    | 36,824                   | 30,028    |
| Depreciation and amortization  | 5,620                                    | 3,889     | 10,650                   | 7,701     |
| General and administrative (including \$1,538 in 2006 and \$2,359 in 2005 to affiliates and related parties) | 1,669                                    | 1,907     | 3,041                    | 3,373     |
| Advisory fees  | 2,161                                    | 1,785     | 4,187                    | 3,538     |
| Total operating expenses   | 27,923                                   | 23,154    | 54,702                   | 44,640    |
| Operating income   | 2,899                                    | 1,680     | 6,423                    | 2,791     |
| Other income (expense):  |  |           |                          |           |
| Interest income (including \$424 in 2006 and \$2,336 in 2005 from affiliates and related parties)            | 794                                      | 1,051     | 1,668                    | 1,897     |
| Gain on foreign currency transaction   | 2  | 228       | 4                        | 228       |
| Mortgage and loan interest   | (13,195)                                 | (9,560)   | (25,918)                 | (17,971)  |
| Litigation settlement  | 1,804                                    |           | 1,804                    |           |
| Net income fee   |  | 325       |                          |           |
| Other income   | 50                                       | 234       | 307                      | 234       |
| Total other income (expense)   | (10,545)                                 | (7,722)   | (22,135)                 | (15,612)  |
| Loss before gain on land sales, equity in earnings of investees and minority interest                        | (7,646)                                  | (6,042)   | (15,712)                 | (12,821)  |
| Gain on land sales   | 8,690                                    | 2,394     | 9,021                    | 2,404     |
| Equity in earnings (losses) of investees   | (173)                                    | (45)      | (69)                     | 1,146     |
| Minority interest  | 361                                      | (181)     | 189                      | (26)      |
| Income (loss) from continuing operations   | 1,232                                    | (3,874)   | (6,571)                  | (9,297)   |
| Add: income tax benefit  | 1,196                                    | 73        | 955                      | 3,492     |
| Net income (loss) from continuing operations   | 2,428                                    | (3,801)   | (5,616)                  | (5,805)   |
| Income from discontinued operations (See NOTE 9)   | 3,418                                    | 210       | 2,729                    | 9,977     |
| Less: income tax expense   | (1,196)                                  | (73)      | (955)                    | (3,492)   |
| Net income from discontinued operations  | 2,222                                    | 137       | 1,774                    | 6,485     |
| Net income (loss)  | 4,650                                    | (3,664)   | (3,842)                  | 680       |
| Preferred dividend requirement   | (53)                                     | (53)      | (105)                    | (105)     |

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|   |          |            |            |        |
|---|----------|------------|------------|--------|
| Net income (loss) applicable to common shares | \$ 4,597 | \$ (3,717) | \$ (3,947) | \$ 575 |
|---|----------|------------|------------|--------|

The accompanying notes are an integral part of these Consolidated Financial Statements.

**Table of Contents**

**TRANSCONTINENTAL REALTY INVESTORS, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS - Continued**  
**(Unaudited)**

|   | For the Three Months Ended<br>June 30, |           | For the Six Months Ended<br>June 30, |           |
|---|--|-----------|--------------------------------------|-----------|
|   | 2006                                   | 2005      | 2006                                 | 2005      |
| (dollars in thousands, except per share)                                    |  |           |                                      |           |
| <b>Basic earnings per share:</b>  |  |           |                                      |           |
| Income (loss) from continuing operations                                    | \$ 0.30                                | \$ (0.49) | \$ (0.72)                            | \$ (0.75) |
| Discontinued operations   | 0.28                                   | 0.02      | 0.22                                 | 0.82      |
| Net income (loss) applicable to common shares                               | \$ 0.58                                | \$ (0.47) | \$ (0.50)                            | \$ 0.07   |
| <b>Diluted earnings per share:</b>  |  |           |                                      |           |
| Net income (loss) from continuing operations                                | \$ 0.29                                | \$ (0.49) | \$ (0.72)                            | \$ (0.75) |
| Income from discontinued operations   | 0.27                                   | 0.02      | 0.22                                 | 0.82      |
| Net income (loss) applicable to common shares                               | \$ 0.56                                | \$ (0.47) | \$ (0.50)                            | \$ 0.07   |
| <b>Weighted average common shares used in computing earnings per share:</b> |  |           |                                      |           |
| Basic   | 7,900,869                              | 7,900,869 | 7,900,869                            | 7,900,869 |
| Diluted   | 8,190,519                              | 8,094,267 | 8,190,519                            | 8,094,267 |

Series C Cumulative Convertible Preferred stock (convertible after September 30, 2006 into common stock estimated to be approximately 249,650 shares) and options to purchase 40,000 shares of TCI's common stock were excluded from the computation of diluted earnings per share for the three months ended June 30, 2005 and the six months ended June 30, 2006 and 2005, because the effect of their inclusion would be antidilutive.

The accompanying notes are an integral part of these Consolidated Financial Statements.

**Table of Contents**

**TRANSCONTINENTAL REALTY INVESTORS, INC.**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

**For the Six Months Ended June 30, 2006**

(dollars in thousands)

(Unaudited)

|  | Preferred Stock |        | Common Stock |        |            | Paid-in<br>Capital | Treasury<br>Stock | Accumulated<br>Deficit | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Stockholders<br>Equity |
|--|-----------------|--------|--------------|--------|------------|--------------------|-------------------|------------------------|---|------------------------|
|  | Shares          | Amount | Shares       | Amount | Amount     |                    |                   |                        |   |                        |
| Balance, January 1, 2006   | 30,000          | \$     | 7,900,869    | \$ 81  | \$ 256,494 | \$ (3,086)         | \$ (1,846)        | \$ (464)               | \$ 251,179  |                        |
| Comprehensive income:  |                 |        |              |        |            |                    |                   |                        |   |                        |
| Unrealized gain on foreign<br>currency translation   |                 |        |              |        |            |                    |                   | (194)                  | (194)   |                        |
| Unrealized gain on marketable<br>securities  |                 |        |              |        |            |                    |                   | 863                    | 863   |                        |
| Net income (loss)  |                 |        |              |        |            |                    | (3,842)           |                        | (3,842)   |                        |
| Series C Cumulative Convertible<br>Preferred Stock cash dividends<br>(\$7.00 per share per year) |                 |        |              |        | (105)      |                    |                   |                        | (105)   |                        |
| Balance, June 30, 2006   | 30,000          | \$     | 7,900,869    | \$ 81  | \$ 256,389 | \$ (3,086)         | \$ (5,688)        | \$ 205                 | \$ 247,901  |                        |

The accompanying notes are an integral part of these Consolidated Financial Statements.

**Table of Contents****TRANSCONTINENTAL REALTY INVESTORS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

|   | <b>For the Six Months Ended<br/>June 30,</b> |             |
|---|--|-------------|
|   | <b>2006</b>                                  | <b>2005</b> |
|   | <b>(dollars in thousands)</b>                |             |
| <b>Cash Flows from Operating Activities</b>   |  |             |
| Reconciliation of net income (loss) to net cash provided by (used in) operating activities        |  |             |
| Income (loss) from continuing operations  | \$ (5,616)                                   | \$ (5,805)  |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities |  |             |
| Depreciation and amortization   | 10,848                                       | 8,019       |
| Amortization of deferred borrowing costs  | 1,400  | 2,149       |
| Provision for asset impairment  |  | 1,580       |
| Income tax (benefit) expense  | (955)  | (3,492)     |
| Gain on sale of real estate   | (9,021)                                      | (2,404)     |
| Equity in (earnings) losses of investees  | 69   | (1,146)     |
| Gain on foreign currency transaction  | (4)  | (228)       |
| (Income) loss allocated to minority interest  | (189)  | 26          |
| Decrease (increase) in interest receivable  | 387  | 1,917       |
| (Increase) decrease in other assets   | 3,378  | (1,342)     |
| Increase (decrease) in interest payable   | (886)  | (237)       |
| Increase (decrease) in other liabilities  | (4,394)                                      | 2,233       |
| Net cash provided (used) by operating activities  | (4,983)                                      | 1,270       |
| <b>Cash Flows from Investing Activities</b>   |  |             |
| Collections on notes receivable   | 9,061  | 3,655       |
| Funding of notes receivable   | (2,211)                                      | (2,048)     |
| Acquisition of real estate  | (46,855)                                     | (23,633)    |
| Real estate improvements and construction   | (8,201)                                      | (24,029)    |
| Proceeds from sale of real estate   | 17,332                                       | 25,889      |
| Distributions from equity investees, net  |  | 313         |
| Deposits on pending purchases and financings  | (988)  | (4,345)     |
| Net cash used in investing activities   | (31,862)                                     | (24,198)    |
| <b>Cash Flows from Financing Activities</b>   |  |             |
| Payments on notes payable   | (38,128)                                     | (50,418)    |
| Proceeds from notes payable   | 80,847                                       | 58,596      |
| Dividends paid to preferred shareholders  | (105)  | (53)        |
| Payments to advisor   |  | (8,746)     |
| Deferred financing costs  | (2,499)                                      | (1,421)     |
| Net cash provided by financing activities   | 40,115                                       | (2,042)     |
| <b>Discontinued Operations</b>  |  |             |
| Cash provided by (used in) operating activities   | (365)  | (1,365)     |
| Cash provided by investing activities proceeds from sale of real estate                           | 3,444  | 14,314      |
| Net cash provided (used) by discontinued operations   | 3,079  | 12,949      |
| Net increase (decrease) in cash and cash equivalents  | 6,349  | (12,021)    |

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|  |           |          |
|--|-----------|----------|
| Cash and cash equivalents, beginning of period | 5,462     | 21,845   |
| Cash and cash equivalents, end of period       | \$ 11,811 | \$ 9,824 |

The accompanying notes are an integral part of these Consolidated Financial Statements.

**Table of Contents****TRANSCONTINENTAL REALTY INVESTORS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS - Continued****(Unaudited)**

|  | <b>For the Six Months Ended<br/>June 30,</b> |             |
|--|--|-------------|
|  | <b>2006</b>                                  | <b>2005</b> |
|  | <b>(dollars in thousands)</b>                |             |
| <b>Supplemental Disclosures of Cash Flow Information:</b>            |  |             |
| Cash paid for interest   | \$ 26,414                                    | \$ 19,706   |
| <b>Schedule of non cash investing and financing activities:</b>      |  |             |
| Notes payable assumed on purchase of real estate                     | 10,475                                       | 13,006      |
| Increase in minority interest related to acquisition of real estate  | 14,835                                       |             |
| Notes payable assumed by buyer on sale of real estate                |  | 738         |
| Real estate purchased from affiliate decreasing affiliate receivable | 11,273                                       | 1,631       |
| Note payable assumed by affiliate                                    | 4,000  |             |

The accompanying notes are an integral part of these Consolidated Financial Statements.

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**Table of Contents**

**TRANSCONTINENTAL REALTY INVESTORS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1. BASIS OF PRESENTATION**

Transcontinental Realty Investors, Inc. ( TCI ) is a Nevada corporation and successor to a California business trust which was organized on September 6, 1983. TCI invests in real estate through direct ownership, leases and partnerships. TCI also invests in mortgage loans on real estate.

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America for interim financial information and in conjunction with the rules and regulations of the Securities and Exchange Commission and accordingly, do not include all of the information and footnotes required by generally accepted accounting principles in the United States of America for complete financial statements. In the opinion of management of TCI, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of TCI's consolidated financial position, consolidated results of operations and consolidated cash flows have been included. Operating results for the six-month period ended June 30, 2006, are not necessarily indicative of the results that may be expected for the year ended December 31, 2006.

The consolidated balance sheet at December 31, 2005 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles in the United States of America for complete financial statements.

You should read these consolidated financial statements in conjunction with the consolidated financial statements and footnotes thereto in our annual report on Form 10-K for the year ended December 31, 2005. Certain balances for 2005 have been reclassified to conform to the 2006 presentation.

Operating results for the six-month period ended June 30, 2006, are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. For further information, refer to the Consolidated Financial Statements and notes included in TCI's Annual Report on Form 10-K for the year ended December 31, 2005 (the 2005 Form 10-K ).

Effective March 31, 2003, TCI's financial results have been consolidated with and included in the American Realty Investors, Inc. ( ARI ) Forms 10-K, 10-Q and related consolidated financial statements. As of June 30, 2006, ARI owned 82.2 percent of the outstanding TCI common shares.

***Adoption of New Accounting Standards***

*SFAS 123-R.* Effective January 1, 2006 (the Effective Date ), the Company adopted SFAS No. 123-R using the modified prospective method. SFAS No. 123-R must be applied not only to newly awarded stock options but also to previously awarded stock options that were not fully vested on the Effective Date. All of TCI's stock option grants were fully vested as of the Effective Date. Furthermore, TCI had no outstanding stock option grants that were modified or settled after the Effective Date; therefore, TCI will recognize no additional compensation costs for previously awarded stock option grants. In December 2005, the Company's Board of Directors terminated all stock option plans and has no intent at the present to reinstate any stock option programs.

*EITF 04-5.* At its June 2005 meeting, the Emerging Issues Task Force, or EITF, reached a consensus regarding Issue No. 04-5 (EITF 04-5), *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights.* EITF 04-5 was effective immediately for all newly-formed limited partnerships and for existing limited partnership agreements that are modified. The guidance is effective for existing limited-partnership agreements that are not modified no later than the beginning of the first reporting period in fiscal years beginning after December 15, 2005. The guidance provides a framework for addressing the question of when a general partner, as defined in EITF 04-5, should consolidate a limited partnership. The EITF has concluded that the general partner of a limited partnership should consolidate a limited partnership unless (1) the limited partners possess substantive kick-out rights as defined in paragraph B20 of FIN 46(R), *Consolidation of Variable Interest Entities* , or (2) the limited partners possess substantive participating rights similar to the rights described in Issue 96-16, *Investor's Accounting for an Investee When the Investor has a Majority of the Voting Interest but the Minority Shareholder or Shareholders have Certain Approval or Veto Rights.* The FASB has amended Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures*, and EITF 96-16, to conform and align with the guidelines set forth in EITF 04-5. There was no impact to our financial condition or results of operations from the adoption of EITF 04-5.

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*EITF 06-3.* At its June 2006 meeting, the EITF ratified the consensus regarding Issue No. 06-3 (EITF 06-3), *How Taxes Collected from Customers and Remitted to Governmental Authorities Should be Presented in the Income Statement (That is, Gross versus Net Presentation)*. EITF 06-3 is effective for interim and annual periods beginning after December 15, 2006, with earlier application

**Table of Contents****TRANSCONTINENTAL REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued**

added, and certain excise taxes. The consensus indicates that gross vs. net income statement classification of those taxes within its scope is an accounting policy decision. In addition, for taxes within its scope, the consensus requires the following disclosures: the accounting policy elected for these taxes and the amounts of the taxes reflected gross (as revenue) in the income statement on an interim and annual basis. We do not believe there will be an impact to our financial condition or results of operations from the adoption of EITF 06-3.

*FIN 48.* On July 13, 2006, the FASB issued Interpretation 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109*, (FIN 48), which clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The standard also provides guidance on derecognizing, classification, interest, and penalties, accounting in interim periods, disclosure, and transition. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006, and are to be applied to all tax positions upon initial adoption of this standard. Only tax positions that meet a more-likely-than-not recognition threshold at the effective date may be recognized or continue to be recognized upon adoption of FIN 48. We are currently evaluating the impact, if any, to our financial condition and results of operations from the adoption of FIN 48.

**NOTE 2. REAL ESTATE**

In 2006, TCI purchased the following properties:

| Property                                     | Location           | Units /<br>Sq. Ft./Acres | Purchase<br>Price    | Net Cash<br>Paid/<br>(Received) | Debt<br>Incurred | Interest<br>Rate     | Maturity<br>Date |
|--|--------------------|--------------------------|----------------------|---------------------------------|------------------|----------------------|------------------|
| <b>First Quarter</b>                         |                    |                          |                      |                                 |                  |                      |                  |
| <b>Land</b>                                  |                    |                          |                      |                                 |                  |                      |                  |
| Circle C Ranch                               | Austin, TX         | 1,092.0 Acres            | \$ 25,569            | \$                              | \$ 25,569        | 8.75% <sup>(1)</sup> | 03/08            |
| Pioneer Crossing                             | Austin, TX         | 38.5 Acres               | 614 <sup>(2)</sup>   | 614                             | 1,515            | 8.75 <sup>(1)</sup>  | 06/08            |
| Southwood 1394                               | Tallahassee, FL    | 14.5 Acres               | 1,150                | 477                             | 748              | 8.50 <sup>(1)</sup>  | 02/08            |
| Valley Ranch 20                              | Farmers Branch, TX | 20.0 Acres               | 4,673                | 1,892                           | 3,038            | 8.50 <sup>(1)</sup>  | 02/08            |
| Woodmont Fairway Office                      | Dallas, TX         | 5.9 Acres                | 3,833                | 1,014                           | 3,000            | 8.25 <sup>(1)</sup>  | 01/07            |
| Woodmont Merit Drive                         | Dallas, TX         | 9.3 Acres                | 4,560                | 1,868                           | 2,964            | 8.00                 | 03/07            |
| <b>Apartments</b>                            |                    |                          |                      |                                 |                  |                      |                  |
| Anderson Estates Apts                        | Oxford, MS         | 48 Units                 | 1,144 <sup>(3)</sup> | 148                             | 996              | 9.50 <sup>(1)</sup>  | 12/20            |
| David Jordan Phase II                        | Greenwood, MS      | 32 Units                 | 743 <sup>(3)</sup>   | 98                              | 645              | 8.50 <sup>(1)</sup>  | 04/19            |
| David Jordan Phase III                       | Greenwood, MS      | 40 Units                 | 812 <sup>(3)</sup>   | 122                             | 690              | 8.75 <sup>(1)</sup>  | 07/22            |
| Leflore Estates / Curtis Moore<br>Apartments | Greenwood, MS      | 104 Units                | 2,114 <sup>(3)</sup> | 337                             | 1,777            | 7.00                 | 02/22            |
| Monticello III Estates                       | Monticello, AR     | 32 Units                 | 644 <sup>(3)</sup>   | 96                              | 548              | 7.00                 | 01/22            |
| Riverwalk Phase I                            | Greenwood, MS      | 32 Units                 | 455 <sup>(3)</sup>   | 99                              | 356              | 8.50                 | 02/19            |
| Riverwalk Phase II                           | Greenwood, MS      | 72 Units                 | 1,584 <sup>(3)</sup> | 226                             | 1,358            | 8.25 <sup>(1)</sup>  | 02/19            |
| <b>Second Quarter</b>                        |                    |                          |                      |                                 |                  |                      |                  |
| <b>Land</b>                                  |                    |                          |                      |                                 |                  |                      |                  |
| Forney Land                                  | Forney, TX         | 34.9 Acres               | 3,945                | (3,926)                         |                  |                      |                  |
| Parc at Clarksville                          | Clarksville, TN    | 10.4 Acres               | 541                  |                                 | 547              | 8.00                 | 08/06            |
| Senlac Hutton                                | Farmers Branch, TX | 5.9 Acres                | 1,050                | (949)                           |                  |                      |                  |
| Waco 42                                      | Waco, TX           | 42.8 Acres               | 531                  | (112)                           | 398              | 8.00                 | 05/09            |
| <b>Office Building</b>                       |                    |                          |                      |                                 |                  |                      |                  |

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One Hickory

Farmers Branch, TX 102,615 Sq. Ft. 12,214<sup>(4)</sup>

- (1) Variable interest rate.
- (2) Purchased from ARI; purchase price is equal to ARI's cost.
- (3) Net of minority interest and other liabilities assumed.
- (4) Property received in satisfaction of a note receivable from Income Opportunity Realty Investors, Inc. ( IORI. )

**Table of Contents****TRANSCONTINENTAL REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued**

In September 2005, TCI deposited \$1.75 million with a seller for the purchase of partnership and member interests in 14 separate apartments and apartment developments located in the Southeast. Each partnership or membership purchase will be closed separately, pending lender approval and other conditions. TCI's total cash investment can be up to \$3.6 million if all interests are purchased. In January 2006, the Company acquired controlling interest in seven of the 14 properties. TCI's investment was funded from the \$1.75 million deposit.

In 2005, TCI purchased the following properties:

| Property                            | Location           | Units/<br>Sq. Ft./Acres | Purchase<br>Price | Net Cash<br>Paid/<br>(Received) | Debt<br>Incurred        | Interest<br>Rate     | Maturity<br>Date     |
|-------------------------------------|--------------------|-------------------------|-------------------|---------------------------------|-------------------------|----------------------|----------------------|
| <b>First Quarter</b>                |                    |                         |                   |                                 |                         |                      |                      |
| <b>Office Buildings</b>             |                    |                         |                   |                                 |                         |                      |                      |
| Two Hickory <sup>(3)</sup>          | Farmers Branch, TX | 96,127 Sq. Ft.          | \$ 11,502         | \$                              | \$ 7,430 <sup>(1)</sup> | 4.90% <sup>(2)</sup> | 05/06                |
| <b>Land</b>                         |                    |                         |                   |                                 |                         |                      |                      |
| Mandahl Bay                         | US Virgin Islands  | 50.8 Acres              | 7,000             | 4,101                           | 3,500                   | 7.00                 | 07/05 <sup>(7)</sup> |
| Mandahl Bay (Gilmore)               | US Virgin Islands  | 1.0 Acres               | 96                | 104                             |                         |                      |                      |
| Mandahl Bay (Chung)                 | US Virgin Islands  | .8 Acres                | 95                | 101                             |                         |                      |                      |
| <b>Second Quarter</b>               |                    |                         |                   |                                 |                         |                      |                      |
| <b>Apartments</b>                   |                    |                         |                   |                                 |                         |                      |                      |
| Foxwood <sup>(3)</sup>              | Memphis, TN        | 220 Units               | 6,988             |                                 | 5,609 <sup>(1)</sup>    | 6.54                 | 01/08                |
| Parc at Metro Center <sup>(4)</sup> | Nashville, TN      | 144 Units               | 817               | (378)                           | 817                     | 5.65                 | 09/46                |
| Mission Oaks <sup>(4)</sup>         | San Antonio, TX    | 228 Units               | 573               | 573                             |                         | 5.30                 | 09/46                |
| <b>Land</b>                         |                    |                         |                   |                                 |                         |                      |                      |
| Alliance Airport                    | Tarrant County, TX | 12.7 Acres              | \$ 850            | 892                             |                         |                      |                      |
| Mandahl Bay (Marina)                | US Virgin Islands  | 24.0 Acres              | 2,000             | 2,101                           |                         |                      |                      |
| Southwood <sup>(5)</sup>            | Tallahassee, FL    | 13.0 Acres              | 525               | 555                             |                         |                      |                      |
| West End <sup>(6)</sup>             | Dallas, TX         | .2 Acres                | 49                | 52                              |                         |                      |                      |
| <b>Office Buildings</b>             |                    |                         |                   |                                 |                         |                      |                      |
| Park West                           | Farmers Branch, TX | 243,416 Sq. Ft.         | 10,000            | 4,715                           | 6,500                   | 7.50 <sup>(2)</sup>  | 05/06                |

(1) Assumed debt.

(2) Variable rate.

(3) Property received from ARI for payment of a note receivable. See NOTE 3. NOTES AND INTEREST RECEIVABLE.

(4) Initial construction loan funding to purchase land and begin apartment construction. Does not represent actual units purchased.

(5) Purchased a 50 percent interest in this land tract.

(6) Purchased a 37.5 percent interest in this land tract.

(7) Debt was extended to January 2007.

In 2006, TCI sold the following properties:

| Property | Location | Units/<br>Acres/Sq. Ft. | Sales<br>Price | Net Cash<br>Received | Debt<br>Discharged | Gain<br>on<br>Sale |
|----------|----------|-------------------------|----------------|----------------------|--------------------|--------------------|
|----------|----------|-------------------------|----------------|----------------------|--------------------|--------------------|

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*First Quarter*

**Land**

|                  |                    |            |          |          |    |        |
|------------------|--------------------|------------|----------|----------|----|--------|
| Hollywood Casino | Farmers Branch, TX | 10.5 Acres | \$ 3,225 | \$ 1,297 | \$ | \$ 331 |
|------------------|--------------------|------------|----------|----------|----|--------|

*Second Quarter*

**Apartments**

|                       |               |           |       |       |       |       |
|-----------------------|---------------|-----------|-------|-------|-------|-------|
| Plantation Apartments | Tulsa, OK     | 138 Units | 2,750 | 638   | 2,191 | 432   |
| Willo-Wick Apartments | Pensacola, FL | 152 Units | 6,500 | 2,806 | 2,827 | 2,860 |

**Table of Contents****TRANSCONTINENTAL REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued**

| Property            | Location     | Units/<br>Acres/Sq. Ft. | Sales<br>Price | Net Cash<br>Received | Debt<br>Discharged | Gain<br>on<br>Sale |
|---------------------|--------------|-------------------------|----------------|----------------------|--------------------|--------------------|
| <b>Land</b>         |              |                         |                |                      |                    |                    |
| McKinney Ranch Land | McKinney, TX | 123.9 Acres             | \$ 16,591      | \$ 6,004             | \$ 10,051          | \$ 3,389           |
| McKinney Ranch Land | McKinney, TX | 44.5 Acres              | 10,289         | 10,031               |                    | 5,301              |

In 2005, TCI sold the following properties:

| Property                      | Location        | Units/<br>Acres/ Sq. Ft. | Sales<br>Price | Net Cash<br>Received | Debt<br>Discharged | Gain on<br>Sale |
|-------------------------------|-----------------|--------------------------|----------------|----------------------|--------------------|-----------------|
| <b>First Quarter</b>          |                 |                          |                |                      |                    |                 |
| <b>Office Building</b>        |                 |                          |                |                      |                    |                 |
| Institute Place               | Chicago, IL     | 144,915 Sq. Ft.          | \$ 14,460      | \$ 4,843             | \$ 7,792           | \$ 10,061       |
| <b>Industrial Warehouse</b>   |                 |                          |                |                      |                    |                 |
| 5700 Tulane                   | Atlanta, GA     | 67,850 Sq. Ft.           | 816            | 738                  |                    | 294             |
| <b>Land</b>                   |                 |                          |                |                      |                    |                 |
| Granbury Station              | Fort Worth, TX  | 15.7 Acres               | 1,003          | 265                  | 738 <sup>(1)</sup> | 10              |
| <b>Second Quarter</b>         |                 |                          |                |                      |                    |                 |
| <b>Land</b>                   |                 |                          |                |                      |                    |                 |
| Alamo Springs/Lemmon Carlisle | Dallas, TX      | 2.8 Acres                | 7,674          | 5,587                | 1,744              | 2,394           |
| <b>Office Building</b>        |                 |                          |                |                      |                    |                 |
| 9033 Wilshire                 | Los Angeles, CA | 44,253 Sq. Ft.           | 12,000         | 4,366                | 6,506              | 2,162           |
| Bay Plaza I                   | Tampa, FL       | 75,780 Sq. Ft.           | 4,682          | 3,253                | 961                | 919             |
| Bay Plaza II                  | Tampa, FL       | 78,882 Sq. Ft.           | 4,719          | 1,114                | 3,284              | (199)           |

(1) Assumed debt.

At June 30, 2006, TCI had the following properties under construction:

| Property             | Location           | Units     | Amount<br>Expended | Additional<br>Amount<br>to Expend | Construction<br>Loan<br>Funding |
|----------------------|--------------------|-----------|--------------------|-----------------------------------|---------------------------------|
| Laguna Vista         | Farmers Branch, TX | 206 Units | \$ 9,376           | \$ 11,729                         | \$ 17,741                       |
| Legends of El Paso   | El Paso, TX        | 240 Units | 6,318              | 11,766                            | 16,040                          |
| Mission Oaks         | San Antonio, TX    | 228 Units | 14,236             | 3,234                             | 15,636                          |
| Parc at Maumelle     | Maumelle, AR       | 240 Units | 12,456             | 6,242                             | 16,829                          |
| Parc at Metro Center | Nashville, TN      | 144 Units | 4,022              | 8,593                             | 11,141                          |
| Parc at Rogers       | Rogers, AR         | 152 Units | 801                | 23,391                            | 20,825                          |

**Table of Contents****TRANSCONTINENTAL REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued****NOTE 3. NOTES AND INTEREST RECEIVABLE**

Notes and interest receivable at June 30, 2006 consisted of the following:

| <b>Borrower</b>                                | <b>Maturity Date</b> | <b>Interest Rate</b> | <b>Amount</b> | <b>Security</b>                            |
|--|----------------------|----------------------|---------------|--|
| <b>Performing loans:</b>                       |                      |                      |               |  |
| Edina Park Plaza Associates, LP <sup>(1)</sup> | Sep-2017             | 7.63%                | \$ 14,519     | Office building, Durham, NC                |
| Dallas Fund XVII LP                            | Oct-2006             | 9.00                 | 4,440         | Partnership interests and lawsuit proceeds |
| Edina Park Plaza Associates, LP <sup>(1)</sup> | Sep-2017             | 7.63                 | 3,297         | Office building, Durham, NC                |
| Pioneer Austin Development                     | Oct-2008             | 10.00                | 2,889         | 33 acres undeveloped land, Austin, TX      |
| Countryside LP                                 | Jan-2007             | 7.25                 | 2,300         | Class A LP units                           |
| Basic Capital Management <sup>(1)</sup>        | Apr-2008             | Prime+2.00           | 1,523         | Retail building, Cary, NC                  |
| Luna Mira Lago LP                              | On demand            | 10.00                | 1,500         | Undeveloped land, Dallas, TX               |
| Garden Centura LP                              | N/A                  | 7.00                 | 1,336         | Excess cash flow from partnership          |
| Basic Capital Management                       | Apr-2008             | Prime+2.00           | 1,252         | Industrial building, Arlington, TX         |
| Miscellaneous related party notes              | Various              | Various              | 1,400         | Various security interests                 |
| Other notes less than \$1 million each         | Various              | Various              | 2,235         | Various security interests                 |
| Accrued interest                               |                      |                      | 1,102         |  |
| Total performing loans                         |                      |                      | 37,793        |  |
| <b>Non-performing loans:</b>                   |                      |                      |               |  |
| 400 St. Paul                                   | Jul-2006             | 8.00                 | 4,893         | Office building, Dallas, TX                |
| Total  |                      |                      | \$ 42,686     |  |

<sup>(1)</sup> Related party.

In March 2006, TCI sold 10.5 acres of undeveloped land in Dallas, Texas for \$3.2 million, financing \$1.5 million of the sales price in the form of a demand note bearing interest at the rate of ten percent per annum. In July 2006, the \$1.5 million note was satisfied in full in exchange for 24.9 acres of undeveloped land in Crowley, Texas.

In March 2005, TCI entered into an agreement to advance a third party \$3.2 million for development costs relating to single-family residential lots in Austin, Texas. These advances are secured by stock in the borrower and hold a second lien on the undeveloped land. The secured note bears interest at 10 percent, requires semi-annual payments, and matures in March 2008. In September 2005, the total amount authorized under this advance was increased to \$5.0 million. As of March 31, 2006, TCI had advanced \$3.2 million to the borrower. TCI also guaranteed an \$18 million loan secured by a first lien on the undeveloped land. In September 2005, TCI purchased for \$4.1 million a subsidiary of Tacco Universal, a related party, that holds two notes receivable from the borrower for \$3.0 and \$1.0 million, respectively. These notes are secured by approximately 142 acres of undeveloped land and membership interest in the borrower. These secured notes bear interest at 12 percent, have an interest reserve for payments that is added to the principal balance on a monthly basis, and matured in June 2005. Both loans were extended to September 2005 and upon maturity were paid under the advance referred to at the beginning of this paragraph. In March 2006, TCI acquired all of the interests in the borrower, including ownership of the Austin, Texas land. The land is secured by the \$18 million first mortgage and a \$3 million subordinated loan. In March 2006, TCI secured a development loan of \$31.3 million (secured by the Austin, Texas land), of which \$18 million was used to pay the existing first mortgage. The development loan matures in March 2008 and bears interest at Prime + one percent. The Company intends to develop the land for sale to single-family residential builders.

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In December 2004, TCI sold the Centura Tower office building located in Dallas, Texas to Garden Centura LP and retained a one percent non-controlling general partner interest and a four percent limited partner interest. TCI has certain obligations to loan the buyer funds for rent abatements, tenant improvements, leasing commissions and other cash requirements. Through June 30, 2006, TCI has funded \$1.3 million of these obligations and has recorded a note receivable from the partnership. This note bears interest at a fixed rate of seven percent per annum. The note will be paid out of excess cash flow or from sales proceeds, but only after certain partner preferred returns are paid.

In December 2003, TCI purchased from ARI a note receivable secured by a second lien on 33 acres of undeveloped land located in Austin, Texas. TCI acquired the loan from ARI for \$2.4 million in satisfaction of certain loans made by TCI to ARI. The loan bears interest at the rate of ten percent per annum. Monthly interest only payments are required beginning in November 2007. The loan matures in October 2008.

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**Table of Contents**

**TRANSCONTINENTAL REALTY INVESTORS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued**

In July 2003, TCI advanced \$2.3 million to the Class A Limited Partners of TCI Countryside LP of which TCI is the general partner. The loan bears interest at the rate of 7.25 percent per annum and matures in January 2007. TCI also agreed to advance \$1.1 million to the Class A Limited Partners by advancing \$105,000 in July 2003 and every year thereafter for ten years. This loan bears interest at 7.25 percent and matures in July 2012. As of September 2005, TCI had advanced \$315,000. In October 2005, TCI agreed to settle the remaining obligations under this loan by paying a lump sum of \$425,000, making the total advanced \$740,000. After January 2007, TCI may retire the Class A Limited Partners interest in exchange for cancellation of the note.

In March 2002, TCI sold the 174,513 Sq. Ft. Hartford Office Building located at 400 St. Paul in Dallas, Texas, for \$4.0 million and provided \$4.0 million in seller financing plus an additional \$1.4 million line of credit for leasehold improvements all in the form of a first lien mortgage note. The note bears interest at a variable interest rate, requires monthly interest only payments, and matures in March 2007. As of September 2005, TCI funded \$896,000 of the additional line of credit. TCI determined during the third quarter 2005 to classify this note as non-performing. Effective January 1, 2006, TCI no longer accrues interest income on this note. TCI has made no additional advances on this loan nor have any additional payments been received. This loan is not considered impaired due to the fair value of the collateral being sufficient to cover the current loan balance and accrued interest at June 30, 2006.

In August 2001, TCI agreed to loan Dallas Fund XVII LP up to \$5.6 million secured by a second lien on an office building in Dallas, Texas. The note receivable initially had a variable interest rate, required monthly interest payments and originally matured in January 2003. TCI funded a total of \$4.3 million on this note. In January 2003, TCI agreed to extend the maturity date to May 2003. The collateral used to secure TCI's second lien was subsequently seized by the first lien holder. In March 2004, TCI agreed to accept an assignment of claims in litigation as additional security for the note. TCI later agreed to a modification agreement with the borrower effective November 2003. As of the modified effective date, accrued interest of \$582,000 was added to the principal balance of the note; the interest rate was fixed at nine percent per annum with all principal and interest due November 2005. TCI also received certain pledge and security agreements in various partnership interests belonging to the borrower and received various assignments of proceeds from asset sales in certain entities owned by the borrower. TCI reduced accrued interest and principal by \$1.5 million from the receipt of notes receivable assigned to TCI by the borrower and by \$605,000 from cash received. TCI also received \$1.4 million in January 2005 that was applied to accrued interest and principal effective December 30, 2004. Through June 30, 2006, TCI has advanced an additional \$2.73 million to the borrower.

*Related Party Transactions.* In August 2005, TCI sold 8.8 acres to IORI for \$6.7 million. For a period of one year following closing and 90 days thereafter, IORI has the right to convey the land to TCI for the original sales price, plus a 12 percent preferred return per annum accruing from the closing date. This transaction has been treated as a financing by TCI, with a note payable of \$6.7 million recorded.

In June 2005, TCI purchased a subsidiary of a related party, decreasing the affiliate receivable by \$4.1 million.

In October 2004, TCI sold the Durham Centre in Durham, North Carolina to Edina Park Plaza Associates, LP, a limited partnership in which the managing general partner is a subsidiary of ARI, for \$21.3 million cash plus an all-inclusive wrap-around note of \$14.5 million. The note bears interest at a fixed rate of 7.63 percent, requires monthly interest payments, and matures in September 2007. TCI also made a loan to the partnership for \$3.3 million. The note bears interest at a fixed rate of 7.63 percent, requires monthly interest payments, and matures in September 2017.

In March 2004, TCI sold a K-Mart in Cary, North Carolina to Basic Capital Management ( BCM ) for \$3.2 million, including the assumption of debt. TCI also provided \$1.5 million of the purchase price as seller financing. The unsecured note bears interest at the prime rate plus two percent and matures in April 2008.

In March 2004, TCI sold the Texstar Warehouse in Arlington, Texas to BCM for \$2.4 million, including the assumption of debt. TCI also provided \$1.3 million of the purchase price as seller financing. The unsecured note bears interest at the prime rate plus two percent and matures in April 2008.

In October 2003, TCI sold the One Hickory office building in Farmers Branch, Texas to IORI, a related party. TCI owns approximately 25 percent of the outstanding common shares of IORI. TCI sold One Hickory to IORI for \$12.2 million and financed \$12.0 million of the purchase price with a note receivable bearing interest at 5.49 percent per annum and maturing in June 2006. The \$12.2 million sales price approximated

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TCI's initial cost of acquiring the property in 2002 from American Realty Investors, Inc. (ARI), a related party. ARI owns approximately 82 percent of the outstanding common shares of TCI. IORI immediately sold One Hickory together with 202 acres of undeveloped land to a partnership, the general partner of which was then an affiliate of ARI for a total sales price of \$37.2 million. In May 2006, the partnership sold One Hickory and the undeveloped land back to IORI for \$37.2 million. IORI in turn sold One Hickory back to TCI, in satisfaction of the \$12.0 million note payable by IORI.

**Table of Contents****TRANSCONTINENTAL REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued****NOTE 4. INVESTMENT IN UNCONSOLIDATED REAL ESTATE ENTITIES**

*Unconsolidated real estate entities.* TCI's investment in unconsolidated real estate entities at June 30, 2006 included equity securities of two publicly traded real estate entities, IORI and ARI, related parties, and interests in real estate joint venture partnerships. ARI is a related party that owns 82.2 percent of TCI's common stock and consolidates TCI's financial accounts and operations.

TCI accounts for its investment in IORI and ARI and the joint venture partnerships using the equity method. Garden Centura, L.P. is accounted for on the cost method.

TCI's investment in real estate entities at June 30, 2006, was as follows:

| Investee             | Percentage of TCI's<br>Ownership at<br>June 30, 2006 | Carrying Value of<br>Investment at<br>June 30, 2006 | Market Value <sup>(a)</sup><br>of Investment at<br>June 30, 2006 |
|----------------------|--|---|--|
| IORI                 | 24.9%  | \$ 6,345  | \$ 7,260   |
| ARI                  | 6.4%   | 11,797  | 6,409  |
| Garden Centura, L.P. | 5.0%   | 6,098   |  |
|                      |  | 24,240  |  |
| Other                |  | 351   |  |
|                      |  | \$ 24,591   |  |

(a) Based on stock closing price on June 30, 2006 and is not necessarily indicative of the fair market value of the investee's net assets. Set forth below is summarized results of operations of equity investees for the first six months of 2006 and 2005.

|   | 2006       | 2005      |
|---|------------|-----------|
| Revenues  | \$ 66,802  | \$ 83,768 |
| Equity in earnings of investees   | 81         | (28)      |
| Property operating expenses   | (52,499)   | (49,903)  |
| Depreciation  | (5,341)    | (4,209)   |
| Interest expense  | (16,474)   | (14,223)  |
| Income (loss) before gains on sale of real estate and discontinued operations | (7,431)    | 15,405    |
| Gain on sale of real estate   | 4,314      | 72        |
| Income (loss) from discontinued operations                                    |            |           |
| Net income (loss)   | \$ (3,117) | \$ 15,477 |

**NOTE 5. MARKETABLE EQUITY SECURITIES**

TCI owns equity securities of Realty Korea CR-REIT Co., Ltd. No. 1 representing approximately a 9.2 percent ownership interest. This investment is considered an available-for-sale security. Due to increases in market price, TCI recognized an unrealized gain of \$490,000 and

\$863,000 for the three and six month periods ending June 30, 2006, respectively.

**NOTE 6. RELATED PARTIES**

Cash advances either to or from TCI, through its advisor, Prime Income Asset Management LLC ( Prime ) are unsecured, generally do not have specific repayment terms and have been reflected in TCI 's financial statements as other assets or other liabilities. Effective July 1, 2005, TCI and Prime agreed to charge interest on the outstanding balance of funds advanced to or from TCI. The interest rate, set at the beginning of each quarter, is the prime rate plus one percent on the average daily cash balances advanced.

**Table of Contents****TRANSCONTINENTAL REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued**

The following table reconciles the beginning and ending amounts due from (to) Prime from TCI as of June 30, 2006.

|  | <b>PRIME</b>      | <b>IORI</b> |
|--|-------------------|-------------|
| Balance, December 31, 2005             | \$ (11,668)       | \$          |
| Cash transfers                         | 31,956            |             |
| Cash repayments                        | (32,894)          |             |
| Repayments through property transfers  | (4,614)           |             |
| Fees payable to affiliate              | (4,922)           |             |
| Insurance proceeds received by advisor | 11,270            |             |
| Payables clearing through Prime        | (664)             |             |
| Advances to operating account, net     | 7,905             |             |
| <b>Balance, June 30, 2006</b>          | <b>\$ (3,631)</b> | <b>\$</b>   |

In August 2005, TCI conveyed ownership in 8.8 acres of undeveloped land in Farmers Branch, Texas to IORI for \$6.7 million. For a period of one year following closing and 90 days thereafter, IORI has the right (but not the obligation) to transfer ownership back to TCI for the original sales price, plus a 12 percent preferred return per annum accruing from the closing date. This transaction has been treated as a financing by TCI, with a note payable of \$6.7 million recorded.

At June 30, 2006, TCI's other assets includes \$1.2 million due from Garden Centura LP for advances made to fund certain tenant concessions. In addition, at June 30, 2006, TCI owed \$867,000 to Regis Property Management for management fees and sales commissions.

*Returns on Metra Properties.* In April 2002, TCI sold 12 apartment properties to partnerships controlled by Metra Capital, LLC ( Metra ). Innovo Group, Inc. ( Innovo ) is a limited partner in the partnerships that purchased the properties. A former director of ARI controlled approximately 11.7 percent of the outstanding common stock of Innovo. TCI accounted for the sales as financing transactions, and TCI reported the assets and the new debt incurred by Metra on its financial statements. The partnership agreements for each of these partnerships stated that the Metra Partners, as defined, were to receive cash flow distributions at least quarterly in an amount sufficient to provide them with a 15 percent cumulative compounded annual rate of return on their invested capital, as well as a cumulative compounded annual amount of 0.50 percent of the average outstanding balance of the mortgage indebtedness secured by any of these properties. These distributions to the Metra Partners had priority over distributions to any other partners. In August 2004, ARI, TCI, and IORI instituted an action in Texas State District Court regarding the transaction. During April 2005, resolution of the litigation occurred, settling all liabilities remaining from the original partnership arrangements which included a return of investor equity, cessation of preferential returns, prospective asset management fees and miscellaneous fees and transactions costs from the Plaintiffs as a prepayment of a preferred return, along with a delegation of management and corresponding payment of management fees to Prime, and a motion to dismiss the action as a part of the resolution. Of the prepayment, the Company recognized expenses of \$462,000 and a reduction in liabilities of \$2.1 million during the second quarter of 2005.

**NOTE 7. LOANS AND INTEREST PAYABLE**

In July 2005, TCI secured a line of credit for \$10.0 million for the acquisition and financing of land tracts. The line of credit bears interest at the prime rate plus one percent, requires interest only payments, and matures in February 2009. Each land tract funding has a \$2.0 million limit on the loan amount, requires interest only payments at the line of credit's variable rate, and has a maturity date of 18 months.

In May 2005, TCI received a loan from Shinhan Bank in the amount of \$4.0 million. The note bears interest at the prime rate plus two percent, requires monthly interest only payments, and matures in May 2008. The loan is collateralized by TCI's equity holdings in Realty Korea CR-REIT Co., Ltd. No. 1 and by equity securities owned by an affiliate.

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In February 2005, TCI received a loan from HSW Partners in the amount of \$5.0 million. The note bears interest at eight percent per annum, requires semi-annual interest payments, and matured in July 2006. The loan is collateralized by certain partnership interests that hold three apartments owned by TCI. Anytime before maturity, the lender has the option to convert the outstanding loan balance into general and limited partnership units in each of the partnerships, subject to HUD approval.

**Table of Contents****TRANSCONTINENTAL REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued**

In 2006, TCI refinanced the following properties:

| Property                | Location           | Sq. Ft./Units/<br>Rooms/Acres | Debt     |            | Net Cash<br>Received | Interest<br>Rate     | Maturity<br>Date |
|-------------------------|--------------------|-------------------------------|----------|------------|----------------------|----------------------|------------------|
|                         |                    |                               | Incurred | Discharged |                      |                      |                  |
| <b>Apartments</b>       |                    |                               |          |            |                      |                      |                  |
| <i>First Quarter</i>    |                    |                               |          |            |                      |                      |                  |
| Hunters Glen            | Midland, TX        | 212 Units                     | \$ 2,475 | \$ 1,804   | \$ 421               | 7.23% <sup>(1)</sup> | 02/09            |
| <b>Land</b>             |                    |                               |          |            |                      |                      |                  |
| West End                | Dallas, TX         | 5.3 Acres                     | 9,000    | 2,000      | 6,079                | 8.00 <sub>(1)</sub>  | 03/07            |
| <i>Second Quarter</i>   |                    |                               |          |            |                      |                      |                  |
| <b>Land</b>             |                    |                               |          |            |                      |                      |                  |
| Payne Land              | Las Colinas, TX    | 109.9 Acres                   | 5,683    |            | 5,591                | 9.00                 | 12/07            |
| <b>Office Buildings</b> |                    |                               |          |            |                      |                      |                  |
| One Hickory             | Farmers Branch, TX | 102,615 Sq. Ft.               | 9,300    | 6,858      | 2,308                | 6.93                 | 06/10            |
| Forum Office Building   | Richmond, VA       | 79,791 Sq. Ft.                | 6,000    | 4,721      | 1,152                | 7.75                 | 07/13            |

(1) Variable rate.

In 2005, TCI refinanced the following properties:

| Property                | Location          | Sq. Ft./Units/<br>Rooms/Acres | Debt     |            | Net Cash<br>Received | Interest<br>Rate     | Maturity<br>Date |
|-------------------------|-------------------|-------------------------------|----------|------------|----------------------|----------------------|------------------|
|                         |                   |                               | Incurred | Discharged |                      |                      |                  |
| <i>First Quarter</i>    |                   |                               |          |            |                      |                      |                  |
| <b>Office Buildings</b> |                   |                               |          |            |                      |                      |                  |
| Bridgeview Plaza        | LaCrosse, WI      | 116,008 Sq. Ft.               | \$ 7,197 | \$ 6,304   | \$ 649               | 7.25% <sup>(1)</sup> | 03/10            |
| <b>Shopping Centers</b> |                   |                               |          |            |                      |                      |                  |
| Dunes Plaza             | Michigan City, IN | 223,869 Sq. Ft.               | 3,750    | 2,685      | 658                  | 7.50 <sub>(1)</sub>  | 01/10            |
| <i>Second Quarter</i>   |                   |                               |          |            |                      |                      |                  |
| <b>Apartments</b>       |                   |                               |          |            |                      |                      |                  |
| Autumn Chase            | Midland, TX       | 64 Units                      | 1,166    | 797        | 317                  | 5.88 <sub>(1)</sub>  | 05/35            |
| Courtyard               | Midland, TX       | 133 Units                     | 1,342    | 966        | 266                  | 5.88 <sub>(1)</sub>  | 05/35            |
| Southgate               | Odessa, TX        | 180 Units                     | 1,879    | 1,712      | 61                   | 5.88 <sub>(1)</sub>  | 05/35            |
| <b>Hotel</b>            |                   |                               |          |            |                      |                      |                  |
| The Majestic            | Chicago, IL       | 55 Rooms                      | 3,225    |            | 3,066                | 6.40                 | 06/10            |

(1) Variable rate.

**NOTE 8. OPERATING SEGMENTS**

Significant differences among the accounting policies of the operating segments as compared to the Consolidated Financial Statements principally involve the calculation and allocation of administrative expenses. Management evaluates the performance of each of the operating segments and allocates resources to them based on their operating income and cash flow. Excluded from segment assets are assets of \$125.0 million at June 30, 2006, and \$132.1 million at June 30, 2005, which are not identifiable with an operating segment. There are no intersegment

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revenues and expenses and TCI conducted all of its business within the United States, with the exception of Hotel Akademia, a 161 room hotel in Wroclaw, Poland, which began operations in 2002.

**Table of Contents****TRANSCONTINENTAL REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued**

Presented below is the operating income of each operating segment for the three and six months ended June 30, 2006 and 2005, and each segment's assets at June 30.

| <b>Commercial</b>                                |                  |                   |                   |               |                    |
|--|------------------|-------------------|-------------------|---------------|--------------------|
| <b>For the Three Months Ended June 30, 2006</b>  | <b>Land</b>      | <b>Properties</b> | <b>Apartments</b> | <b>Hotels</b> | <b>Total</b>       |
| Rents  | \$ 144           | \$ 8,993          | \$ 19,980         | \$ 1,705      | \$ 30,822          |
| Property operating expenses                      | 611              | 5,407             | 11,606            | 849           | 18,473             |
| Depreciation                                     | 2                | 2,332             | 3,083             | 203           | 5,620              |
| Interest   | 2,750            | 2,956             | 7,245             | 244           | 13,195             |
| Gain on land sales                               | 8,690            |                   |                   |               | 8,690              |
| Segment income (loss)                            | \$ 5,471         | \$ (1,702)        | \$ (1,954)        | \$ 409        | \$ 2,224           |
| Real estate improvements and construction Assets | 1,644<br>237,366 | 4,044<br>195,355  | 2,410<br>540,304  | 37<br>28,021  | 8,135<br>1,001,046 |
| <b>Property Sales:</b>                           |                  |                   |                   |               |                    |
| Sales price                                      | \$ 26,880        | \$                | \$ 9,250          | \$            | \$ 36,130          |
| Cost of sales                                    | 18,190           |                   | 5,958             |               | 24,148             |
| Gain on sale                                     | \$ 8,690         | \$                | \$ 3,292          | \$            | \$ 11,982          |

| <b>Commercial</b>                                |                |                   |                   |               |                  |
|--|----------------|-------------------|-------------------|---------------|------------------|
| <b>For the Three Months Ended June 30, 2005</b>  | <b>Land</b>    | <b>Properties</b> | <b>Apartments</b> | <b>Hotels</b> | <b>Total</b>     |
| Rents  | \$ 148         | \$ 5,442          | \$ 16,479         | \$ 2,765      | \$ 24,834        |
| Property operating expenses                      | 607            | 3,730             | 9,966             | 1,270         | 15,573           |
| Depreciation                                     | (14)           | 1,735             | 1,988             | 180           | 3,889            |
| Interest   | 1,081          | 1,567             | 6,527             | 385           | 9,560            |
| Gain on land sales                               | 2,394          |                   |                   |               | 2,394            |
| Segment income (loss)                            | \$ 868         | \$ (1,590)        | \$ (2,002)        | \$ 930        | \$ (1,794)       |
| Real estate improvements and construction Assets | 275<br>151,065 | 711<br>125,956    | 8,011<br>494,751  | 8<br>33,163   | 9,005<br>804,935 |
| <b>Property Sales:</b>                           |                |                   |                   |               |                  |
| Sales price                                      | \$ 7,674       | \$ 21,401         | \$                | \$            | \$ 29,075        |
| Cost of sales                                    | 5,280          | 18,519            |                   |               | 23,799           |
| Gain on sale                                     | \$ 2,394       | \$ 2,882          | \$                | \$            | \$ 5,276         |

| <b>Commercial</b>                             |             |                   |                   |               |              |
|---|-------------|-------------------|-------------------|---------------|--------------|
| <b>For the Six Months Ended June 30, 2006</b> | <b>Land</b> | <b>Properties</b> | <b>Apartments</b> | <b>Hotels</b> | <b>Total</b> |

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|   |           |            |            |          |            |
|---|-----------|------------|------------|----------|------------|
| Rents                                     | \$ 301    | \$ 18,310  | \$ 38,973  | \$ 3,541 | \$ 61,125  |
| Property operating expenses               | 722       | 10,378     | 23,219     | 2,505    | 36,824     |
| Depreciation                              | 14        | 4,620      | 5,442      | 574      | 10,650     |
| Interest                                  | 4,954     | 5,748      | 14,447     | 769      | 25,918     |
| Gain on land sales                        | 9,021     |            |            |          | 9,021      |
| Segment income (loss)                     | \$ 3,632  | \$ (2,436) | \$ (4,135) | \$ (307) | \$ (3,246) |
| Real estate improvements and construction | 1,750     | 5,586      | 4,159      | 37       | 11,532     |
| Assets                                    | 237,366   | 195,355    | 540,304    | 28,021   | 1,001,046  |
| <b>Property Sales:</b>                    |           |            |            |          |            |
| Sales price                               | \$ 30,105 | \$         | \$ 9,250   | \$       | \$ 39,355  |
| Cost of sales                             | 21,084    |            | 5,958      |          | 27,042     |
| Gain on sale                              | \$ 9,021  | \$         | \$ 3,292   | \$       | \$ 12,313  |

**Table of Contents****TRANSCONTINENTAL REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued**

| For the Six Months Ended June 30, 2005           | Commercial |            |            |          |            |
|--|------------|------------|------------|----------|------------|
|  | Land       | Properties | Apartments | Hotels   | Total      |
| Rents  | \$ 282     | \$ 11,285  | \$ 31,625  | \$ 4,239 | \$ 47,431  |
| Property operating expenses                      | 1,369      | 7,161      | 18,985     | 2,513    | 30,028     |
| Depreciation                                     | (3)        | 3,539      | 3,805      | 360      | 7,701      |
| Interest   | 2,369      | 2,868      | 12,007     | 727      | 17,971     |
| Gain on land sales                               | 2,404      |            |            |          | 2,404      |
| Segment income (loss)                            | \$ (1,049) | \$ (2,283) | \$ (3,172) | \$ 639   | \$ (5,865) |
| Real estate improvements and construction Assets | 423        | 1,756      | 21,832     | 18       | 24,029     |
|  | 151,065    | 125,956    | 494,751    | 33,163   | 804,935    |
| <b>Property Sales:</b>                           |            |            |            |          |            |
| Sales price                                      | \$ 8,677   | \$ 36,677  | \$         | \$       | \$ 45,354  |
| Cost of sales                                    | 6,273      | 23,441     |            |          | 29,714     |
| Gain on sale                                     | \$ 2,404   | \$ 13,236  | \$         | \$       | \$ 15,640  |

The tables below reconcile the segment information to the corresponding amounts in the Consolidated Statements of Operations:

|  | For the Six Months Ended June 30, |            |
|--|-----------------------------------|------------|
|  | 2006                              | 2005       |
| Segment operating income (loss)              | \$ (3,246)                        | \$ (5,865) |
| Other non-segment items of income (expense): |                                   |            |
| General and administrative                   | (3,041)                           | (3,373)    |
| Advisory fees                                | (4,187)                           | (3,538)    |
| Interest income                              | 1,668                             | 1,897      |
| Gain (loss) on foreign currency transaction  | 4                                 | 228        |
| Net income fee                               |                                   |            |
| Other income (expense)                       | 307                               | 234        |
| Litigation settlement                        | 1,804                             |            |
| Equity in earnings of investees              | (69)                              | 1,146      |
| Minority interest                            | 189                               | (26)       |
| Income tax benefit                           | 955                               | 3,492      |
| Net loss from continuing operations          | \$ (5,616)                        | \$ (5,805) |

**NOTE 9. DISCONTINUED OPERATIONS**

Effective January 1, 2002, TCI adopted Statement of Financial Accounting Standard No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, which established a single accounting model for the impairment or disposal of long-lived assets, including discontinued operations. This statement requires that the operations related to properties that have been sold or properties that are intended to be sold be presented as discontinued operations in the statement of operations for all periods presented, and properties intended to be sold are to be designated as held-for-sale on the balance sheet. In the event of a future sale, TCI is required to reclassify portions of previously reported operations to discontinued operations within the Statement of Operations.

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For the six months ended June 30, 2006 and 2005, income from discontinued operations relates to properties TCI sold or intends to sell in 2006 as well as properties TCI sold during 2004 and 2005 or intends to sell in 2006. The following table summarizes revenue and expense information for the properties sold and held-for-sale.

**Table of Contents****TRANSCONTINENTAL REALTY INVESTORS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued**

|   | For the Three Months<br>Ended June 30, |          | For the Six Months<br>Ended June 30, |          |
|---|--|----------|--------------------------------------|----------|
|   | 2006                                   | 2005     | 2006                                 | 2005     |
| Revenue:  |  |          |                                      |          |
| Rental  | \$ 1,760                               | \$ 3,907 | \$ 3,798                             | \$ 7,834 |
| Property operations                             | 728                                    | 2,846    | 2,149                                | 5,641    |
|   | 1,032                                  | 1,061    | 1,649                                | 2,193    |
| Expenses:                                       |  |          |                                      |          |
| Interest  | 867                                    | 1,934    | 2,014                                | 3,558    |
| Depreciation                                    | 39                                     | 222      | 198                                  | 318      |
|   | 906                                    | 2,156    | 2,212                                | 3,876    |
| Gain on sale of operations                      | 3,292                                  | 2,882    | 3,292                                | 13,237   |
| Write-down of assets held-for-sale              |  | (1,580)  |                                      | (1,580)  |
| Equity in investees gain on sale of real estate |  | 3        |                                      | 3        |
| Income tax expense                              | (1,196)                                | (73)     | (955)                                | (3,492)  |
| Net income from discontinued operations         | \$ 2,222                               | \$ 137   | \$ 1,774                             | \$ 6,485 |

**NOTE 10. COMMITMENTS AND CONTINGENCIES**

*Partnership Obligations.* TCI is the limited partner in six partnerships that are currently constructing residential properties. As permitted in the respective partnership agreements, TCI intends to purchase the interests of the general partner and any other limited partners in these partnerships subsequent to the final completion of these construction projects. The amounts paid to purchase the non-affiliated partners are limited to development fees earned by the non-affiliated partners, and are set forth in the respective partnership agreements. The total amount of the expected buyouts remaining at June 30, 2006 is approximately \$2.3 million. TCI is a non-controlling general and limited partner in a real estate partnership and is obligated to fund approximately \$1.9 million through September 30, 2006, for certain partnership obligations.

*Commitments.* In September 2005, TCI deposited \$1.8 million with a seller for the purchase of partnership and member interests in 14 separate apartments and apartment developments located in the Southeast. Each partnership or membership purchase will be closed separately, pending lender approval and other conditions. TCI's total cash investment can be up to \$3.6 million if all interests are purchased.

*Liquidity.* The Company's principal liquidity needs are funding normal recurring expenses, meeting debt service requirements, funding capital expenditures, funding development costs not otherwise covered by construction loans and funding new property acquisitions not otherwise covered by acquisition financing. Management believes the Company's liquidity needs will be satisfied by existing cash balances, cash flows generated by operations and provided by financing activities as well as cash provided from asset sales.

*Litigation.* TCI is involved in various lawsuits arising in the ordinary course of business. Management is of the opinion that the outcome of these lawsuits will have no material impact on TCI's financial condition, results of operations or liquidity.

*Guarantees.* In September 2005, TCI guaranteed a loan of \$1.6 million for a subsidiary of Unified Housing Foundation ( UHF ), a related party. This loan is secured by a first lien on 22.3 acres of land held by the related party.

In February 2004, various subsidiaries of TCI guaranteed a \$10 million line of credit for ARI. The subsidiaries of TCI also pledged and assigned assets, in the form of securities and partnership interests in construction properties, as additional collateral for this line of credit.



**Table of Contents**

**TRANSCONTINENTAL REALTY INVESTORS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - Continued**

**NOTE 11. SUBSEQUENT EVENTS**

In August 2006, a TCI subsidiary and IORI, as co-borrowers, obtained a loan commitment of up to \$42.6 million from Metropolitan National Bank. The loan matures in August 2008 and bears interest at the rate of 8.6 percent per annum. The loan requires quarterly interest payments beginning in October 2006. The loan is secured by a) approximately 99 acres of land located in Dallas, Texas and owned by the TCI subsidiary (which the TCI subsidiary purchased from ARI in August 2006) and b) 202 acres of land located in Dallas, Texas which is owned by IORI. The loan is also guaranteed by TCI. Proceeds of the new loan will be used to retire the existing debt on the collateral and to fund additional investments for TCI and IORI.

Other events occurring after the date of these financial statements are included within each note, as appropriate.

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**Table of Contents**

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

***WARNING CONCERNING FORWARD LOOKING STATEMENTS***

The following discussion should be read in conjunction with the financial statements and notes thereto appearing elsewhere in this report.

This Report on Form 10-Q may contain forward-looking statements within the meaning of the federal securities laws, principally, but not only, under the caption Management's Discussion and Analysis of Financial Condition and Results of Operations. We caution investors that any forward-looking statements in this report, or which management may make orally or in writing from time to time, are based on management's beliefs and on assumptions made by, and information currently available to, management. When used, the words anticipate, believe, expect, intend, may, might, plan, estimate, project, should, will, result and similar expressions which do not relate solely to historical matters are intended to identify forward-looking statements. These statements are subject to risks, uncertainties, and assumptions and are not guarantees of future performance, which may be affected by known and unknown risks, trends, uncertainties, and factors, that are beyond our control. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, estimated, or projected. We caution you that, while forward-looking statements reflect our good faith beliefs when we make them, they are not guarantees of future performance and are impacted by actual events when they occur after we make such statements. We expressly disclaim any responsibility to update our forward-looking statements, whether as a result of new information, future events or otherwise. Accordingly, investors should use caution in relying on past forward-looking statements, which are based on results and trends at the time they are made, to anticipate future results or trends.

Some of the risks and uncertainties that may cause our actual results, performance, or achievements to differ materially from those expressed or implied by forward-looking statements include, among others, the factors listed and described at Item 1A Risk Factors in the Company's Annual Report on Form 10-K, which investors should review. There have been no changes from the risk factors previously described in the Company's Form 10-K for the fiscal year ended December 31, 2005 (the Form 10-K).

Other sections of this report may also include suggested factors that could adversely affect our business and financial performance. Moreover, we operate in a very competitive and rapidly changing environment. New risks emerge from time to time and it is not possible for management to predict all such matters; nor can we assess the impact of all such matters on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. Given these uncertainties, investors should not place undue reliance on forward-looking statements as a prediction of actual results. Investors should also refer to our quarterly reports on Form 10-Q for future periods and current reports on Form 8-K as we file them with the SEC, and to other materials we may furnish to the public from time to time through Forms 8-K or otherwise.

***Overview***

TCI invests in real estate through acquisitions, leases, and partnerships and in mortgage loans on real estate, including first, wraparound, and junior mortgage loans. TCI is the successor to a California business trust organized on September 6, 1983, which commenced operations on January 31, 1984. On November 30, 1999, TCI acquired all of the outstanding shares of beneficial interest of Continental Mortgage and Equity Trust (CMET), a real estate company, in a tax-free exchange of shares, issuing 1.181 shares of its Common Stock for each outstanding CMET share. TCI accounted for the merger as a purchase.

Prior to January 1, 2000, TCI elected to be treated as a Real Estate Investment Trust (REIT) under Sections 856 through 860 of the Internal Revenue Code of 1986, as amended (the Code). During the third quarter of 2000, TCI no longer met the requirement for tax treatment as a REIT due to a concentration of ownership.

Today, TCI is an externally advised real estate investment company that owns a diverse portfolio of residential apartment communities, office buildings, hotels and other commercial properties. TCI has a preeminent track record as a developer, completing the construction of 19 apartment properties comprising 4,300 units over the last three years. In addition, TCI owns a high-quality portfolio of land held for future development and continues to invest in well-located land tracts in high-growth markets primarily in Texas. As of June 30, 2006, the Company owned approximately 10,400 units in 52 residential apartment communities, 22 commercial properties comprising almost four million rentable square feet and 4 hotels containing a total of 313 rooms. In addition, at June 30, 2006, TCI owned 4,200 acres of land held for development and had over 1,200 apartment units in six projects under construction. The Company currently owns income-producing properties and land in 15 states as well as in Poland and the U.S. Virgin Islands. Prime Income Asset Management, LLC (Prime) is the Company's external advisor. Regis Property Management, LLC, an affiliate of Prime, manages the Company's commercial properties. Regis Hotel I, LLC, another Prime affiliate, manages the Company's hotel investments. TCI engages various third-party companies to lease and manage its apartment properties.



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**Table of Contents*****Critical Accounting Policies***

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America, or GAAP, requires management to use judgment in the application of accounting policies, including making estimates and assumptions. We base our estimates on historical experience and on various other assumptions believed to be reasonable under the circumstances. These judgments affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenue and expenses during the reporting periods. If our judgment or interpretation of the facts and circumstances relating to various transactions had been different, it is possible that different accounting policies would have been applied resulting in a different presentation of our financial statements. From time to time, we evaluate our estimates and assumptions. In the event estimates or assumptions prove to be different from actual results, adjustments are made in subsequent periods to reflect more current information. Below is a discussion of accounting policies that we consider critical in that they may require complex judgment in their application or require estimates about matters that are inherently uncertain.

***Real Estate Held for Investment***

Real estate held for investment is carried at cost. Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* ( SFAS No. 144 ), requires that a property be considered impaired if the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the property. If impairment exists, an impairment loss is recognized, by a charge against earnings, equal to the amount by which the carrying amount of the property exceeds the fair value less cost to sell the property. If impairment of a property is recognized, the carrying amount of the property is reduced by the amount of the impairment, and a new cost for the property is established. Such new cost is depreciated over the property's remaining useful life. Depreciation is provided by the straight-line method over estimated useful lives, which range from five to 40 years.

***Real Estate Held-for-Sale***

Foreclosed real estate is initially recorded at new cost, defined as the lower of original cost or fair value minus estimated costs of sale. SFAS No. 144 also requires that properties held for sale be reported at the lower of carrying amount or fair value less costs of sale. If a reduction in a held for sale property's carrying amount to fair value less costs of sale is required, a provision for loss is recognized by a charge against earnings. Subsequent revisions, either upward or downward, to a held for sale property's estimated fair value less costs of sale are recorded as an adjustment to the property's carrying amount, but not in excess of the property's carrying amount when originally classified as held for sale. A corresponding charge against or credit to earnings is recognized. Properties held for sale are not depreciated.

***Investments in Equity Investees***

TCI may be considered to have the ability to exercise significant influence over the operating and investment policies of certain of its investees. Those investees are accounted for using the equity method. Under the equity method, an initial investment, recorded at cost, is increased by a proportionate share of the investee's operating income and any additional investment and decreased by a proportionate share of the investee's operating losses and distributions received.

***Recognition of Rental Income***

Rental income for commercial property leases is recognized on a straight-line basis over the respective lease terms. Rental income for residential property leases is recorded when due from residents and is recognized monthly as earned, which is not materially different than on a straight-line basis as lease terms are generally for periods of one year or less. For hotel properties, revenues for room sales and guest services are recognized as rooms are occupied and services are rendered.

***Revenue Recognition on the Sale of Real Estate***

Sales of real estate are recognized when and to the extent permitted by Statement of Financial Accounting Standards No. 66, *Accounting for Sales of Real Estate* ( SFAS No. 66 ), as amended by SFAS No. 144. Until the requirements of SFAS No. 66 for

## **Table of Contents**

full profit recognition have been met, transactions are accounted for using the deposit, installment, cost recovery or financing method, whichever is appropriate. When TCI provides seller financing, gain is not recognized at the time of sale unless the buyer's initial investment and continuing investment are deemed to be adequate as determined by SFAS 66 guidelines.

### ***Non-performing Notes Receivable***

TCI considers a note receivable to be non-performing when the maturity date has passed without principal repayment and the borrower is not making interest payments. Any new note receivable that results from a modification or extension of a note considered non-performing will also be considered non-performing, without regard to the borrower's adherence to payment terms.

### ***Interest Recognition on Notes Receivable***

Interest income is not recognized on notes receivable that have been delinquent for 60 days or more. In addition, accrued but unpaid interest income is only recognized to the extent that the net realizable value of the underlying collateral exceeds the carrying value of the receivable.

### ***Allowance for Estimated Losses***

A valuation allowance is provided for estimated losses on notes receivable considered to be impaired. Impairment is considered to exist when it is probable that all amounts due under the terms of the note will not be collected. Valuation allowances are provided for estimated losses on notes receivable to the extent that the investment in the note exceeds management's estimate of fair value of the collateral securing such note.

### ***Fair Value of Financial Instruments***

The following assumptions were used in estimating the fair value of its notes receivable, marketable equity securities, and notes payable. For performing notes receivable, the fair value was estimated by discounting future cash flows using current interest rates for similar loans. For non-performing notes receivable, the estimated fair value of TCI's interest in the collateral property was used. For marketable equity securities, fair value was based on the year-end closing market price of each security. For notes payable, the fair value was estimated using current rates for mortgages with similar terms and maturities.

### ***Liquidity and Capital Resources***

TCI reported a loss from continuing operations of \$5.6 million for the six months ended June 30, 2006, which included the following non-cash items: depreciation and amortization of \$10.7 million, income tax benefit of \$1.0 million, equity in losses of investees of \$69,000 and a gain on sale of real estate of \$9.0 million.

For the six months ended June 30, 2006, net cash used by operating activities was \$5.0 million, due primarily to the loss from continuing operations and a decrease in other liabilities of \$4.4 million.

Also for the six months ended June 30, 2006, net cash used in investing activities was \$31.9 million, primarily due to real estate construction and improvements of \$8.2 million, payments for real estate acquisitions of \$46.9 million, deposits on pending purchases of \$1.0 million and additional fundings on notes receivable of \$2.2 million. These outflows for investing activities were offset by the collection of \$9.1 million on notes receivable and proceeds from sale of real estate of \$17.3 million.

Net cash provided by financing activities of \$40.1 million was due to proceeds received from the funding or refinancing of notes payable of \$80.8 million; offset by cash payments of \$38.1 million to paydown existing notes payable, and \$2.5 million for financing costs.

Net cash from discontinued operations was \$3.1 million due to proceeds from sales of \$3.4 million, offset by negative operating cash flows of \$365,000.

Management reviews the carrying values of TCI's properties and mortgage notes receivable at least annually and whenever events or a change in circumstances indicate that impairment may exist. Impairment is considered to exist if, in the case of a property, the future cash flow from the property (undiscounted and without interest) is less than the carrying amount of the property. For notes receivable, impairment is considered to exist if it is probable that all amounts due under the terms of the note will not be collected. If impairment



## **Table of Contents**

is found to exist, a provision for loss is recorded by a charge against earnings. The mortgage note receivable review includes an evaluation of the collateral property securing each note. The property review generally includes: (1) selective property inspections; (2) a review of the property's current rents compared to market rents; (3) a review of the property's expenses; (4) a review of maintenance requirements; (5) a review of the property's cash flow; (6) discussions with the manager of the property; and (7) a review of properties in the surrounding area.

### ***Related Party Transactions***

In August 2005, TCI sold 8.8 acres to IORI for \$6.7 million. For a period of one year following closing and 90 days thereafter, IORI has the right to convey the land to TCI for the original sales price, plus a 12 percent preferred return per annum accruing from the closing date. This transaction has been treated as a financing by TCI, with a note payable of \$6.7 million recorded.

In June 2005, TCI purchased a subsidiary of a related party, decreasing the affiliate receivable by \$4.1 million.

In October 2004, TCI sold the Durham Centre in Durham, North Carolina to Edina Park Plaza Associates, LP, a limited partnership in which the managing general partner is a subsidiary of ARI, for \$21.3 million cash plus an all-inclusive wrap-around note of \$14.5 million. The note bears interest at a fixed rate of 7.63 percent, requires monthly interest payments, and matures in September 2007. TCI also made a loan to the partnership for \$3.3 million. The note bears interest at a fixed rate of 7.63 percent, requires monthly interest payments, and matures in September 2017.

In March 2004, TCI sold a K-Mart in Cary, North Carolina to Basic Capital Management (BCM) for \$3.2 million, including the assumption of debt. TCI also provided \$1.5 million of the purchase price as seller financing. The unsecured note bears interest at the prime rate plus two percent and matures in April 2008.

In March 2004, TCI sold the Texstar Warehouse in Arlington, Texas to BCM for \$2.4 million, including the assumption of debt. TCI also provided \$1.3 million of the purchase price as seller financing. The unsecured note bears interest at the prime rate plus two percent and matures in April 2008.

In October 2003, TCI sold the One Hickory office building in Farmers Branch, Texas to IORI, a related party. TCI owns approximately 25 percent of the outstanding common shares of IORI. TCI sold One Hickory to IORI for \$12.2 million and financed \$12.0 million of the purchase price with a note receivable bearing interest at 5.49 percent per annum and maturing in June 2006. The \$12.2 million sales price approximated TCI's initial cost of acquiring the property in 2002 from American Realty Investors, Inc. (ARI), a related party. ARI owns approximately 82 percent of the outstanding common shares of TCI. IORI immediately sold One Hickory together with 202 acres of undeveloped land to a partnership, the general partner of which was then an affiliate of ARI for a total sales price of \$37.2 million. In May 2006, the partnership sold One Hickory and the undeveloped land back to IORI for \$37.2 million. IORI in turn sold One Hickory back to TCI, in satisfaction of the \$12.0 million note payable by IORI.

### ***Commitments and Contingencies***

TCI has contractual obligations and commitments primarily with regards to payment of mortgages.

In September 2005, TCI guaranteed a loan of \$1.6 million for a subsidiary of UHF, a related party. This loan is secured by a first lien on 22.3 acres of land held by the related party.

### ***Results of Operations***

TCI had a net income of \$4.6 million and a net loss of \$3.9 million for the three and six months ended June 30, 2006, including gains on the sale of land totaling \$8.7 million and \$9.0 million and income from discontinued operations of \$2.2 million and \$1.8 million, respectively, compared to a net loss of \$3.7 million and net income of \$575,000 in the corresponding periods of 2005, which included gains on sale of land for both periods totaling \$2.4 million and income from discontinued operations of \$137,000 and \$6.5 million, respectively. Fluctuations in this and other components of revenues and expense between the 2006 and 2005 periods are discussed below.

Rents for the three months ended June 30, 2006 increased to \$30.1 million as compared to \$24.8 million in 2005. This increase is mainly due to additional rental income from the completion of new apartment construction projects and from increased occupancy from TCI's commercial properties. These gains were offset by a decrease in hotel revenues due to lower occupancies.



## **Table of Contents**

Rents for the six months ended June 30, 2006 increased to \$61.1 million as compared to \$47.4 million in 2005. This increase is mainly due to additional rental income from the completion of new apartment construction projects, the purchase of additional apartment properties, and from increased occupancy from TCI's commercial properties. These gains were offset by a decrease in hotel revenues due to lower occupancies.

Property operations expense increased to \$18.5 million for the three months ended June 30, 2006, compared to \$15.6 million in 2005. This increase is mainly due to the completion of new apartment construction projects and the purchase of additional apartment properties, offset by lower hotel expenses due to lower occupancies. Property operations expenses for the remaining quarters of 2006 may increase as TCI completes the construction of new apartment projects.

Property operations expense increased to \$36.8 million for the six months ended June 30, 2006, compared to \$30.0 million in 2005. This increase is mainly due to the completion of new apartment construction projects, offset by lower hotel expenses due to lower occupancies. Property operations expenses for the remaining quarters of 2006 may increase as TCI completes the construction of new apartment projects.

Interest income decreased to \$794,000 for the three months ended June 30, 2006, compared to \$1.1 million in 2005. The decrease is primarily due to the payoff or paydown of notes receivable in the first and second quarters of 2006.

Interest income decreased to \$1.7 million for the six months ended June 30, 2006, compared to \$1.9 million in 2005. The decrease is primarily due to the payoff or paydown of notes receivable in the first and second quarters of 2006.

Gain on foreign currency transaction was \$228,000 for the three and six months ending June 30, 2005. Hotel Akademia's long-term debt is denominated in Euros and the transaction of Euros into Polish Zlotys prior to being translated into US Dollars is recorded as a gain or loss on TCI's income statement.

Equity in loss of investees was \$69,000 for the six months ended June 30, 2006, compared to equity in income of investees of \$1.1 million in 2005.

Interest expense increased to \$13.2 million for the three months ended June 30, 2006, from \$9.6 million in 2005. This increase is mainly due to new debt incurred from the completion of new apartment construction projects, plus additional interest from land loans due to new land purchases in 2005 and 2006.

Interest expense increased to \$25.9 million for the six months ended June 30, 2006, from \$18.0 million in 2005. This increase is mainly due to new debt incurred from the completion of new apartment construction projects, plus additional interest from land loans due to new land purchases in 2005 and 2006.

Advisory fees increased to \$2.2 million for the three months ended June 30, 2006 compared to \$1.8 million in 2005. Advisory fees are based on total assets of the company.

Advisory fees increased to \$4.2 million for the six months ended June 30, 2006 compared to \$3.5 million in 2005. Advisory fees are based on total assets of the company.

General and administrative expenses decreased to \$1.7 million for the three months ended June 30, 2006, from \$1.9 million in 2005. The decrease was mainly due to lower professional and consulting fees.

General and administrative expenses decreased to \$3.0 million for the six months ended June 30, 2006, from \$3.4 million in 2005. The decrease was mainly due to lower state and franchise income tax expense, lower professional and consulting fees and lower rent expense. These lower costs were offset by higher spending on legal fees.

For the six months ending June 30, 2006, gains on sale of real estate totaling \$12.3 million were recognized, including \$8.7 million on the sale of McKinney Ranch Land, \$2.8 million on the sale of the Willo-Wick Apartments, \$432,000 on the sale of Plantation Apartments, and \$331,000 on the sale of Hollywood Casino land.

Net income (loss) for the six months ended June 30, 2006 and 2005 from discontinued operations relates to properties TCI sold or intends to sell in 2006 as well as properties TCI sold during 2004 and 2005 or intends to sell in 2006. The following table summarizes revenue and expense information for the properties sold and held-for-sale.



**Table of Contents**

|   | For the Three Months<br>Ended June 30, |               | For the Six Months<br>Ended June 30, |                 |
|---|--|---------------|--------------------------------------|-----------------|
|   | 2006                                   | 2005          | 2006                                 | 2005            |
| <b>Revenue:</b>                                 |  |               |                                      |                 |
| Rental  | \$ 1,760                               | \$ 3,907      | \$ 3,798                             | \$ 7,834        |
| Property operations                             | 728                                    | 2,846         | 2,149                                | 5,641           |
|   | 1,032                                  | 1,061         | 1,649                                | 2,193           |
| <b>Expenses:</b>                                |  |               |                                      |                 |
| Interest  | 867                                    | 1,934         | 2,014                                | 3,558           |
| Depreciation                                    | 39                                     | 222           | 198                                  | 318             |
|   | 906                                    | 2,156         | 2,212                                | 3,876           |
| Gain on sale of operations                      | 3,292                                  | 2,882         | 3,292                                | 13,237          |
| Write-down of assets held-for-sale              |  | (1,580)       |                                      | (1,580)         |
| Equity in investees gain on sale of real estate |  | 3             |                                      | 3               |
| Income tax expense                              | (1,196)                                | (73)          | (955)                                | (3,492)         |
| <b>Net income from discontinued operations</b>  | <b>\$ 2,222</b>                        | <b>\$ 137</b> | <b>\$ 1,774</b>                      | <b>\$ 6,485</b> |

***Tax Matters Update***

Financial statement income varies from taxable income principally due to the accounting for income and losses of investees, gains and losses from asset sales, depreciation on owned properties, amortization of discounts on notes receivable and payable and the difference in the allowance for estimated losses. TCI had a loss for federal income tax purposes in the first six months of 2006 and a loss in the first six months of 2005; therefore, it recorded no provision for income taxes.

At June 30, 2006, TCI had a net deferred tax asset of \$38.0 million due to tax deductions available to it in future years. However, as management cannot determine that it is more likely than not that TCI will realize the benefit of the deferred tax assets, a 100 percent valuation allowance has been established.

***Inflation***

The effects of inflation on TCI's operations are not quantifiable. Revenues from property operations tend to fluctuate proportionately with inflationary increases and decreases in housing costs. Fluctuations in the rate of inflation also affect sales values of properties and the ultimate gain to be realized from property sales. To the extent that inflation affects interest rates, TCI's earnings from short-term investments and the cost of new financings as well as the cost of variable interest rate debt, will be affected.

***Environmental Matters***

Under various federal, state and local environmental laws, ordinances and regulations, TCI may be potentially liable for removal or remediation costs, as well as certain other potential costs, relating to hazardous or toxic substances (including governmental fines and injuries to persons and property) where property-level managers have arranged for the removal, disposal or treatment of hazardous or toxic substances. In addition, certain environmental laws impose liability for release of asbestos-containing materials into the air, and third parties may seek recovery for personal injury associated with such materials.

Management is not aware of any environmental liability relating to the above matters that would have a material adverse effect on TCI's business, assets, or results of operations.

**Table of Contents****ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS**

At June 30, 2006, TCI's exposure to a change in interest rates on its debt is as follows:

|  | <b>Balance</b> | <b>Weighted<br/>Average<br/>Interest Rate</b> | <b>Effect of 1%<br/>Increase In<br/>Base Rates</b> |
|--|----------------|---|--|
| Notes payable:                                   |                |   |  |
| Variable rate                                    | \$ 194,734     | 8.32%   | \$ 1,947   |
| <b>Total decrease in TCI's annual net income</b> |                |   | <b>\$ 1,947</b>                                    |
| Per share  |                |   | \$ 0.25  |

**ITEM 4. CONTROLS AND PROCEDURES**

As of the end of the period covered by this report, TCI carried out an evaluation, under the supervision and with the participation of TCI's Acting Principal Executive Officer and principal accounting officer, of TCI's disclosure controls and procedures pursuant to Exchange Act Rules 13a-15 and 15d-15. Based upon that evaluation, TCI's Acting Principal Executive Officer and principal accounting officer concluded that TCI's disclosure controls and procedures are effective.

There have been no changes in TCI's internal controls over financial reporting during the quarter ending June 30, 2006, that have materially affected, or are reasonably likely to materially affect, TCI's internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

During the period of time covered by the Report, Transcontinental Realty Investors, Inc. (the Company) did not repurchase any of its equity securities. The following table sets forth a summary for the quarter indicating no repurchases were made, and that at the end of the period covered by this Report, a specified number of shares may yet be purchased under the programs specified below:

| <b>Period</b>                | <b>Total Number of<br/>Shares Purchased</b> | <b>Average Price<br/>Paid per Share</b> | <b>Total Number of<br/>Shares Purchased<br/>as Part of Publicly<br/>Announced Program</b> | <b>Maximum Number of<br/>Shares that May<br/>Yet be Purchased<br/>Under the Program<sup>(a)</sup></b> |
|------------------------------|---|---|---|---|
| Balance as of March 31, 2006 |   |   |   | 219,090   |
| April 1-30, 2006             |   | \$                                      |   | 219,090   |
| May 1-31, 2006               |   |   |   | 219,090   |
| June 1-30, 2006              |   |   |   | 219,090   |
| <b>Total</b>                 |   | \$                                      |   |   |

- (a) On June 23, 2000, the TCI Board of Directors approved a share repurchase program for up to 1,409,000 shares of our common stock. This repurchase program has no termination date.

**Table of Contents****ITEM 6. EXHIBITS**

The following exhibits are filed with this report or incorporated by reference as indicated;

| <b>Exhibit Number</b> | <b>Description</b>  |
|-----------------------|---|
| 3.0                   | Articles of Incorporation of Transcontinental Realty Investors, Inc., (incorporated by reference to Exhibit No. 3.1 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1991).   |
| 3.1                   | Certificate of Amendment to the Articles of Incorporation of Transcontinental Realty Investors, Inc., (incorporated by reference to the Registrant's Current Report on Form 8-K, dated June 3, 1996).   |
| 3.2                   | Certificate of Amendment of Articles of Incorporation of Transcontinental Realty Investors, Inc., dated October 10, 2000 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2000).  |
| 3.3                   | Articles of Amendment to the Articles of Incorporation of Transcontinental Realty Investors, Inc., setting forth the Certificate of Designations, Preferences and Rights of Series A Cumulative Convertible Preferred Stock, dated October 20, 1998 (incorporated by reference to Exhibit 3.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 1998).      |
| 3.4                   | Certificate of Designation of Transcontinental Realty Investors, Inc., setting for the Voting Powers, Designations, References, Limitations, Restriction and Relative Rights of Series B Cumulative Convertible Preferred Stock, dated October 23, 2000 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2000).                 |
| 3.5                   | Certificate of Designation of Transcontinental Realty Investors, Inc., Setting for the Voting Powers, Designating, Preferences, Limitations, Restrictions and Relative Rights of Series C Cumulative Convertible Preferred Stock, dated September 28, 2001 (incorporated by reference to Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2001).                  |
| 3.6                   | Articles of Amendment to the Articles of Incorporation of Transcontinental Realty Investors, Inc. Decreasing the Number of Authorized Shares of and Eliminating Series B Preferred Stock dated December 14, 2001 (incorporated by reference to Exhibit 3.7 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2001).  |
| 3.7                   | By-Laws of Transcontinental Realty Investors, Inc. (incorporated by reference to Exhibit No. 3.2 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1991).  |
| 4.1                   | Certificate of Designations, Preferences and Relative Participating or Optional or Other Special Rights, and Qualifications, Limitations or Restrictions Thereof of Series F Redeemable Preferred Stock of American Realty Investors, Inc., dated June 11, 2001 (incorporated by reference to Exhibit 4.1 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2001). |
| 10.0                  | Advisory Agreement dated as of October 1, 2003, between Transcontinental Realty Investors, Inc. and Prime Income Asset Management, LLC (incorporated by reference to Exhibit 10.0 to the registrant's current report on Form 8-K for event occurring October 1, 2003).  |
| 31.1*                 | Certification pursuant to Rule 13a-14 and 15d-14 under the Securities Exchange Act of 1934, as amended.   |
| 32.1*                 | Certification pursuant to 18 U.S.C. 1350.   |

\* Filed herewith.

**Table of Contents**

**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.

TRANSCONTINENTAL REALTY INVESTORS, INC.

Date: August 14, 2006

By: /s/ Steven A. Abney  
Steven A. Abney  
Executive Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer and  
Acting Principal Executive Officer)

31

**Table of Contents**

**TRANSCONTINENTAL REALTY INVESTORS, INC.**

**EXHIBITS TO**

**QUARTERLY REPORT ON FORM 10-Q**

**For the Quarter Ended June 30, 2006**

**Exhibit**

**Number Description of Exhibits**

- 31.1\* Certification pursuant to Rule 13a-14 and 15d-14 under the Securities Exchange Act of 1934, as amended.  
32.1\* Certification pursuant to 18 U.S.C. 1350.

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\* Filed herewith