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Dear Subscribers,

Welcome to the 9th edition of our review of the homebuilding and housing industry. **This edition will deal with the year end 2007 based on the filed 10k's and supplemental reports filed in and around year end.**

So much has happened in the industry since our last writing that we feel it is necessary to break this report into two distinct sections. Section 1 will follow the format of prior reviews, concentrating on the published financial statements. As in the past, **we feel that the 12 largest public homebuilders represent about 25% of the new home sales market. This large sample allows us to draw conclusions about the industry as a whole.** This method of analysis has served us well over the last 3 years. One change; **Beazer Homes (BZH) has been deleted from all of the data due to their postponement of the filing of their reports.** BZH has indicated that when they do file they will be restating at least the prior 3 fiscal years. This meant that so much of the historical data would be changing that the conclusions would not be as reliable if BZH was partially in and partially out. **If anything, the inclusion of the BZH facts would only make the picture worse,** so maybe it is better to exclude the data until all relevant periods can be updated. If you assume that BZH's deteriorating condition is a good proxy for the medium sized private homebuilders and smaller public companies, BZH's inclusion would have been preferred by us to help draw better conclusions about the industry as a whole.

Section 2, available to our subscribers on a special request basis, will attempt to deal with the impact on the industry from the multiple proposals either adopted by congress, proposed by congress, or suggested by many politicians or administrators such as Secretary Paulson. This section will be much more subjective as it will attempt to tie in years of experience with those programs which are likely to be adopted, whether those are the best

programs available or not. **If you would like to receive this Section 2, please email us at the above address.**

You will note that we are now using our new company, **Black Swan Advisors (BSA), for the preparation of this and all future reports.** BSA has been founded to act as an advisor in several different real estate ventures, including a new opportunity fund (in organization) which will concentrate on acquiring distressed real estate assets beginning in mid 2008. **This fund, by design, will focus on a very narrow range of opportunities, based on the insights derived by this analysis.**

Executive Summary, Section 1

As we predicted 2 years ago, **the industry has moved into the highly negative cash flow stage, with declining house sales, shrinking margins, and an inability to liquidate large land holdings. Shrinking credit availability is throwing oil on to the fire.**

Balance sheets and income statements are extremely stressed, with only the accommodation of the banks to thank for no major insolvencies. With no major revival in housing demand in site, enough to stimulate increased absorption and return pricing power, **these conditions will not improve for at least 12 months and more than likely 18 to 24 months.** In fact, we reiterate our prior prognostication that it will take at least 3 major bankruptcies later this year to force consolidation in the industry, which consolidation will be necessary to adjust to a much smaller level of housing demand for at least the next 5 years.

The annualized rate of new home sales has declined from 1.2/1.4 million in late 2006 to 550,000 in March, 2008. This is an astonishing rate of decline. The 550,000 rate would be much lower if it were not for the giveaway prices offered by the homebuilders just to clear inventory to save their companies. This figure is also being levitated by the homebuilders who contribute to its compilation (March 08 New Home Sales Report) in the hopes that better numbers will ease the pressure from lenders. These houses are being sold at tremendous losses, so these housing inventories will not be replaced. Expect the housing sales rate to continue declining until the foreclosure inventory overhang is substantially reduced.

In addition, **we have destroyed a whole generation of homebuyers and mortgage lenders, both needed for the future revival of the industry.** We do not see much structural help from the many programs announced (only some have been enacted) by congress and the administration. This is because they are politically motivated in an election year to appeal to certain narrow special interest groups. None of them have the size or target to have a material positive impact on the industry. Much more detail on these 2 issues will be included in the Section 2 report.

We see the next major move to be actions by the creditor banks and bondholders to start to recognize that their principal and interest is now at risk. Waivers of covenant

defaults will be harder to come by as the financial institutions finally recognize that the homebuilders are giving away their assets to finance bloated overheads and interest payments, and that the remaining asset pools are insufficient to pay the banks and bondholders. **There will likely be some scrambling for collateral as each of these lender groups come to the realization that their loans are at risk. Which lender wants to be held responsible for allowing the assets to disappear?**

As we have been reviewing the carnage to these financial statements **it has occurred to us that we are closer to the end than to the beginning, or in the beginning of the 5th inning, depending on which metaphor you prefer.** From our sample, a few companies will not be around much longer, most will be muddling along working out their problems and trying to get ready for the upswing in a much smaller new home market, and only 1 or 2 will get ready soon enough to take advantage of the few smaller opportunities which will come up. **Our next focus will be to look for the signs that a turn is truly upon us, and how to take advantage of those few smaller opportunities. That is what Section 2 will be all about. Please email us if you would like to be included in our thoughts.**

Analysis of Combined Year End Financial Statements

- 1) **Cash has increased across the board. However, this is a mirage as the companies have not improved cash flow.** In fact, it is apparent that they have cherry picked assets for their liquidity, leaving the companies with the worst assets, which collectively have more negative cash flows going forward. **Positive cash from inventory liquidation is a onetime event, but overhead, debt service, and required land development costs go on until those conditions are changed.**
- 2) Cash flow statements are one-time events based on a number of year end events and transactions designed to help improve the appearance of financial strength. Collectively it appears that there was a positive cash flow of \$5 billion. **However, when you take away the asset impairments (\$12 billion), cash flow was actually \$7 Billion negative.** When you consider that the cash generating capacity of remaining assets has been reduced, **cash flows are likely to be even more negative as companies move forward into 2008 and beyond.** We have been making this point for over 18 months; you need to look at the makeup of remaining assets to understand this phenomenon (see below). **As we have suggested several times in the past, the remaining assets do not have the capacity to generate enough cash flow to service debt.** This means additional assets will have to be sold (now the best of the worst, **so cash flows from remaining assets will be even more negative**) to service debt, leaving fewer and fewer assets to pay principal on debt.

3) **Other analysts have now come to the conclusion that we observed last year, that the asset quality and liquidity has materially deteriorated.** There are several balance sheet indicators to support this view, as follows:

A) The ratio of land to houses under construction has continued to balloon. In fact, most homebuilders are still spending new money to protect entitlements and complete improvements such as grading, roads, utilities, and other conditions agreed to at the time of entitlement approval. Houses are more liquid and more easily disposed of. **All land, especially large tracts, requires additional expenditures and has much fewer buyers, especially when construction and acquisition loans are in such short supply, or are nonexistent.**

A friend recently took a helicopter tour of new projects in Phoenix. He was stunned by the lack of new houses under construction, as all homebuilders are pulling back on starting new houses, by design or by force. This caused us to look at the year end balances in “houses under construction” (HUC). **Over 4 quarters HUC declined by \$8B from \$31 B to \$23 B. Housing Cost of Sales (COS) was \$18 B over this same period. In addition, there was a substantial amount of inventory write downs. So why didn't HUC get reduced more?**

First there is a lot of land in this number for finished lots. Remember that a number of new projects were started in early 2007, so a lot of land was moved from “land under development” to HUC. New model complexes were built, and a lot of additional costs were capitalized.

Remember that homebuilders started 10 to 15% new projects at the beginning of 2007, expecting a turnaround in sales. In order to make “land” on the balance sheet look better, they transferred large groups of finished/semi finished lots to HUC, even though they were starting only a few production houses.

Hence, the sale of houses has not materially reduced the investment in HUC yet. The remaining inventory is probably not very desirable (wrong location, wrong floor plans, and too high prices). Since few new houses are being built, expect further more dramatic sales concessions/price reductions to move this standing inventory.

B) The land which is being sold (i.e. Lennar to Morgan Stanley) consists of smaller finished lots and parcels where the buyer can ascertain the value and development risks. **This leaves the homebuilder with the more risky larger parcels, with more negative cash flows.**

- 4) **The improvement in debt to equity ratios is giving a head fake.** The ratios are improving from definitions in credit agreements, and not from real debt reduction. **While assets were reduced by 19 B from FY 06 to FY 07, outside debt went down only 9.5 B, with some of this reduction in the mortgage warehouse lines. What this really means is that there are fewer assets to pay off liabilities.**

Simplicity is often the best measurement. Like one of the old banking measurements, the quick ratio, we have started looking at a quick ratio as assigned to real estate assets to see if the banks and bond holders will get paid (ignoring the likely arguments about priority and collateral). Here is what we found:

	<u>2006</u>	<u>2007</u>
<u>Cash</u> (balance used for small liab.(50%))	2.0	3.3
<u>Houses Under Construction (75%)</u>	29.24	20.63
<u>Land/Land Develop/JV,etc (50%)</u>	15.2	11.63
<u>Subtotal Assets Available For Debt Liquidation</u>	<u>46.44</u>	<u>35.55</u>
<u>Accounts Payable</u>	7.60	4.00
<u>Accrued Liabilities</u>	8.7	7.9
<u>Unsecured Loans</u>	.29	.30
<u>Secured Loans</u>	2.40	2.1
<u>Bonds</u>	24.7	22.5
<u>Senior Subordinated Debt</u>	.9	1.0
<u>Junior Subordinated Debt</u>		
<u>Subtotal Primary Debt Obligations</u>	<u>44.59</u>	<u>37.8</u>
<u>Net Available for Shareholders</u>	<u>1.85</u>	<u>-2.25</u>
<u>Stated Company Net Worth</u>	39.70	30.10
<u>Percent Net Worth Funded</u>	<u>4.67%</u>	<u>-7.48%</u>

- 5) **Asset write downs are still severely understated.** You can see this from two different indicators, listed below. An associate auditor from one of the big audit firms recently advised us that homebuilders are still fighting to minimize write downs. In any other

industry a new CEO would come in and write everything down as far as he could get away with so that operating earnings would be returned to a positive level. However, in real estate development, if you keep the value high enough you can continue to capitalize carrying costs (and pay executive bonuses), which materially improves the income statement. With declining asset values this is a fool's game. This is very similar to the Level 3 asset valuation problems faced by most of the major banks and investment banks, and it is clear that these asset pools are also severely overvalued.

A) Home sale margins are still negative to flat for the 4th quarter. **If write-down's were appropriate, margins would be returned to a positive 6 to 8%.**

B) **Capitalized interest continues to grow.** If projects were written down to losses, this pool of costs would be decelerating. **It is especially problematic when the asset pools to which these capitalized costs are assigned have a higher and higher component of long lead time land development projects.**

In this climate, homebuilders can no longer talk about future house and land appreciation to make up for the additional development and carrying costs.

6) **Annual housing revenues dropped 50% from FY 06 to FY 07.** The quarterly rate continues to deteriorate even further. A few companies have already reported Q1 08 results, and housing revenues continue to drop. In this same period, the investment in houses under construction was reduced only 20 %. This is just plain old balance sheet/working capital analysis. As your inventory turns over much more slowly, and at much lower margins over variable costs, your investment in inventory stays more elevated and consumes more working capital. Also, **the number of active selling communities has gone up from the end of FY 06 to FY 07 (see Section 2 for more detailed discussion).** We pointed out in an earlier writing that the number of new communities was increased by 10 to 15% early in 2007, which consumed a lot of capital for infrastructure, model complexes, marketing costs, and new speculative inventory. **Those investments must now sit on the books until the projects are sold out.**

7) **The homebuilders are sitting on a significant cache of treasury stock which they bought back in to either pump up their stock prices or for use in employee stock option plans.** Stock prices have dropped so much that these investments will likely represent future additional losses. It is unlikely that they will be used for the employee plans. It is also unlikely that there is a market for these shares, the sale of which would further depress existing market conditions. This is most acute at Lennar and NVR. **NVR has 3 times as many shares in the treasury as they have in free float.** They did not invest in land, but they did invest in themselves, and with the business itself having little value, this treasury stock has an unidentified value. **It is apparent that Barron's was**

correct when they wrote an article on NVR several years ago suggesting that the activity in treasury stock at NVR was for the benefit of the key executives and not the company as a whole.

- 8) **There have also been some material changes on the liability side of the balance sheet, most notably the structure of unsecured credit lines.** These changes have been initiated by the bank groups (note that this is not a criticism but a complement, because any other action, like declaring defaults, would have had much greater negative consequences). As the financial condition (as defined in the credit agreements) of the homebuilders has declined, each one of them has had to seek loan modifications to avoid defaults, mostly in debt service, net worth, and debt to equity covenants. **In return for the waivers, the banks have obtained reductions in total credit lines and pledges of asset reductions designed to increase cash flow available to reduce future bank lending limits.** The early evidence is that there has been some short term improvement but that the long term financial health continues to deteriorate at a rapid rate (see Section 2 report for much greater discussion on this topic and likely outcome).

One major result will be reduced credit availability and the ultimate inability to generate cash flow and profits (**only a few companies might be able to obtain additional new financing, but it will be much, much more expensive**). This condition will come from the current and future allocation of assets. As houses under construction are reduced, more and more of the remaining bank debt is allocated to land, which remaining assets cannot be as easily liquidated. **This means that if there is an upturn in housing demand requiring new housing construction, the homebuilders will not have the capital to finance new inventory.**

We expect much greater aggression by the lender groups (see Section 2 for more discussion) as they see their likely recovery go below zero. **Look for either fights between or lenders and bondholders, or more likely, collaboration between these two groups to minimize administrative costs. This will be especially true due to the accumulation of lender positions by the hedge fund community, which will be looking for much quicker resolutions. Look for a return to the mid 1970's when REIT asset swaps were the norm for settling underwater debt.**

- 9) House product cycles are changing, as they always do. **The target markets for which land was acquired are now moving to smaller houses and closer in locations due to the energy crisis.** This means that current large land holdings will have to be re planned, or in many cases, abandoned due to their distant (read gas dependent) locations from the job centers. **At a minimum, significant amounts of money will have to be spent to re**

plan many of these projects, which mean new architectural/engineering costs as well as city fees. And don't forget the significant holding costs for insurance, property taxes, and debt service where there is any leverage.

This also means that major investments in land infrastructure may have little or no value above land costs (net of write downs). This is especially true as development costs for new improvements are reduced by a general business slowdown.

- 10) Most homebuilders are carrying as assets large tax refunds (this is a different class of refunds from the carry back type). **In order to obtain these refunds the company must generate new profits in the future in a specified period of time.** With high land basis (tax, no write downs), high interest costs, and bloated staffing costs, and no immediate prospect for a significant upturn in housing demand which would increase pricing power, **it is unlikely that any of these companies can generate sufficient profits to obtain these refunds. Look for more write downs of these assets.**
- 11) **To date there has been little movement of joint venture type assets and liabilities on to the balance sheets (as required under Fin 46).** As these ventures face their own financial problems (see Lennar and Land Source as an example) **you will likely see a continued re margining of these loans, with the bulk of the responsibility falling on the larger public homebuilders. In the alternative, look for more chapter 11's of land banks and their investors. The Chapter 11's will not obviate the homebuilder guarantees and keep well agreements**

It is our guess that there are more (more than disclosed in the financial statements) corporate guarantees or "keep well" types of agreements outstanding, which will result in the homebuilders having to accommodate the lenders to these ventures.

This will ultimately lead to more assets and liabilities going on to the balance sheets at much higher debt to equity ratios, resulting in much greater stress on the balance sheets and income statements. **Remember, these are 90% land deals, so they have highly negative cash flows and falling asset values. On a current value basis some of these ventures could be booked with negative equity due to declining market values.**

Last year we suggested that do to their management by less experienced partners, we would look for a lot of negative surprises in these projects, such as environmental, entitlement, and title problems. We call this the "what do you mean our zoning has expired" situation.

- 12) It is clear from the data that unit sales dropped approximately 45 % from FY 2006 to FY 2007. This is not as fast as revenues dropped, so average prices fell faster (or concessions increased, which is the same thing). **As indicated above, early 2008 results indicate that the decline in both unit sales and average sales prices is continuing. This decline will accelerate as the number of popular models available is decreased due to stressed working capital levels (fewer units in production).**

It is also apparent from the data and from early 2008 results that cancellation rates are staying at high levels, so early spring sales reports will likely not hold up as houses are built. This poses a new threat to homebuilders, with more spec houses forced by small inventories, and then having the fear in the market place keep cancellation rates elevated.

- 13) **Government bailout programs have been to date ineffective and are likely to remain so (much more on this in Section 2).** It is our feeling that the programs are too narrowly defined and are aimed at too small a segment of the problem. **The solution lies in reviving the homebuyer and not saving the existing lenders, which most of the programs seem to be aimed at.**

Let's look at the scope (and therefore the likely impact) of a \$20 billion program. Assume that its benefits go ½ to new home sales (read homebuilders) and ½ to existing home sales. It is assumed that if you provide better mortgage conditions you will revive both sets of homebuyers, but as we have stated earlier, we believe this is a fallacious assumption because we feel that ½ of a generation of new homebuyers have been destroyed for at least 5 years.

So you get \$10 billion of fiscal impact for the new home building market. **In the last year and a half new home sales have gone from 1.3 million to 500K, or a reduction 800,000 units. At an average sales price of \$250,000, this is \$200 billion of lost revenue and asset turnover in the industry. The \$20 billion will hardly help return the industry to its 2005/2006 levels of activity.** This is not a perfect example, but it does make the point that these programs are simply not large enough to make a difference either in the homebuilding industry or the US economy in the next year or two.

This is the primary reason we feel that the industry will not revive in the next 12 to 18 months, and why the banks and bondholders will have to take aggressive action to liquidate their loans. It is also the reason we feel that asset acquisition strategies will have to be highly targeted in a shrinking market to get above average returns.

Black Swan Advisors

Prior Write-up, December, 2007, entitled SPECIAL REPORT

Several of our subscribers have requested comments/observations on certain recent events rather than waiting for the normal next cycle, which would be late February based on the December 31, 2007 public filings. We agree that certain recent events (the Lennar transaction, the Bush Paulson Plan-BP Plan) merit immediate observations rather than waiting for 3 more months. There are also some other items which we have decided to comment on directed towards year end reporting.

We are also initiating a new section at the request of subscribers, entitled What Would Change Your Mind from Bearish to Bullish, looking for signs that the decline is coming to an end. That is not a prediction; it is intended to accumulate different views on what our subscribers are looking at to help identify the turn, which by most estimates is still 18 to 24 months away.

The most important observation we can make at this time is that the situation is more systemic than it has been for the last 3 years. For the short term (6 to 12 months) individual company actions and conditions are now subordinated to the influences of the residential real estate market as a whole, with the major trends being the subprime impact on available mortgage financing, homebuyer fear, and the glut of land available for sale at 25 to 40% of its price (note we did not say value) in mid 2006 (see comments on Lennar late November transactions). The quality of the counter tops or the view of the mountains is no longer relevant.

This also means that our focus is shifting with more emphasis on the bank and bond holder groups. **With home builder net worth rapidly diving towards zero, and likely to go past zero by the end of next year, it is the actions or non actions of the lender groups which will determine the outcome. To date these groups have been relatively inactive; we expect that to change rapidly as they realize that their positions are at substantial risk of losing value below par.**

We continue to attach the 2 past executive summaries to provide a reference point for the current comments and to serve as a quick reference to what we have said in the past. **We believe in accountability for our views.**

Lennar Transactions, Year End Nov 30 2007

LEN closed 2 large land transactions before November 30, 2007, their fiscal year end. One was a sale/financing to Morgan Stanley (MS) for 11,000 plus lots in several different states; the second was to a private company in Florida for 8,000 plus lots in Florida (At Dec 07 07 no press release from LEN to confirms this second transaction). These two transactions were designed to generate cash from the sale as well as cash from Federal tax refunds from the losses generated by these sales. Additional transactions before December 31 should also be expected.

As reported by LEN, the MS transaction was priced at a 60% discount to historical cost. Add back the tax refund and the discount looks like only 40%. This looks like it generated \$530 million (\$48,000 per lot avg) from MS and \$200 million from the tax refund. LEN reported no details on the second sale, although those details will surely come out in the next few days.

Here are our observations on the LEN situation and sales:

- 1) We have been predicting industry wide severe cash shortages for almost 3 years. Here is the evidence that the cash crunch is in full swing. You don't take 60% write-downs unless you need to generate cash. **However, given our analysis of the state of the industry, we believe MS overpaid substantially for the lots, and LEN got the better of the deal.**

The biggest impact of this transaction will not be on LEN but on the other homebuilders. After some time this sale will become the ceiling and not the floor. As investors look at what MS paid and what the risks are, and as the home sales market continues to falter, investors will be unwilling to pay this high price for such a large illiquid investment. When you add back at least an average holding period of 4 years (and this may be optimistic for such a large portfolio) the real forward cost of this purchase for MS was well in excess of \$600 million, **and if they picked up any contingent liabilities for bonds, zoning, and other improvements, then the forward cost will likely exceed \$700 million.** As the subsequent buyers found out in the EOP deal, when the packager pays a sub 5% cap rate, he has to sell at sub 4.5% to make a profit, and that is not good for the subsequent buyers. It does not look like MS will be able to quickly spin out large percentages of these lots at big prices. **All of this will discourage other large investors from making similar deals with other homebuilders, so we feel this may be the first and last such transaction for a while, at 40% of book.**

- 2) **These two transactions substantially weakened the LEN balance sheet, and reported losses will continue to escalate.**

MS cherry picked smaller projects which have higher levels of liquidity, leaving

LEN with the larger, riskier land parcels (see comments below on the risks to large land parcels). Over time LEN will have to invest larger sums of cash into the large land parcels to put them into a position to deliver houses. With house prices unlikely to rise much from here over the next 3 years, this will crimp margins at LEN for some time to come. Additionally, holding costs will soon be reported on a quarterly basis which will add to the operating losses, accelerating the elimination of reportable net worth.

It must also be anticipated that these same new accounting standards will be applied to JVs and other off balance sheet projects which are brought on to the financial statements. In the case of LEN this will be an extraordinarily large impact because they have carried so much land off balance sheet. (See Fin 46 comments below)

- 3) The key question is did these transactions actually raise cash permanently for LEN? **Our guess is that these deals provided cash to plug leaks in the cash flow, but did not turn around the corporate cash flow. We made this same observation last year regarding the Newhall transaction, and our view turned out to be the correct one.** Watch the Feb 29 08 Q1 report (due in press release form around Mar 20) to see if cash stayed at reported elevated levels at Nov 30 07 and if AP and other loans were reduced (or was the cash used for other purposes, like re margining debt of JVs). If not, then LEN is consuming this additional cash to solve other unidentified problems. (See below comments on the deterioration of the bank/bondholder positions). **With LEN shrink-wrapping/mothballing projects across the country, previously projected cash flows from inventory reductions will not be happening, leading to a further call on available cash flow. A big use of cash to look at will be the re margining of loans in off balance sheet projects.** You can be sure that the secured banks of JVs/land banks are using every excuse available to cause re margining to occur quickly while home builders have cash from unsecured lines, before those lines are collapsed or restricted.

Bush Paulson Subprime Bailout Plan

This plan is pretty new as of this writing, so our comments are more general in nature since it is a voluntary plan between market participants.

While admirable in its intent, the final version seems to focus on a small subset of buyers from the period January 1 2005 to June 30, 2007. The subset which looks to benefit

from the plan are approximately 500,000 owner occupied home owners who appear to be gainfully employed and are trying to make things work under the current terms of their loans.

The plan does not affect the new home building industry directly since it deals with existing home owners. The positive impact is that if the plan is effective, several hundred thousand homes will not be foreclosed on to compete with new home sales. However, there are also several negatives:

By imposing changes to contract terms, some investors will now not invest in mortgages, thereby further shrinking a declining mortgage pool.

By helping these buyers stay in these houses, you are enslaving them to overpriced houses and mortgages for the next 5 years (most homeowners, especially younger first time buyers) they will stay in these houses until they can sell them at a profit. Based on the condition of the industry today, this might be 5 to 7 years, like it was in the early 1990's. If these houses were foreclosed on now, they would work themselves through the system and these buyers would be back in the market much more quickly. **The new home industry relies on new market entrants at the bottom of the food chain to push everyone above them higher in the home buying pyramid. Without this very large pool of potential buyers the whole recovery will move much more slowly.**

Fiscal Year End Accounting - Significant Impacts

As we suggested about 18 months ago, this fiscal year end would be the one where the rubber meets the road, where the auditors would really zero in on asset values, cash flows, and other going concern issues. Based on my discussions with several senior auditors, that time has come and new audit procedures are in full implementation. There are several areas where the auditors seem to be concentrating:

Net Asset Values

While home builders have been adding to reserves over the last year, our estimation has been that these reserves were not nearly large enough. Our cash flow model indicated in 2007 that write downs approaching 50% of book value were appropriate at absorption levels of early 2007. With absorption levels continuing to decline, the reserves will now likely exceed 50% of book value.

The LEN transaction will be the nail in the coffin for the auditors. This is the first large multi state transaction of significant size which the auditors cannot ignore.

Off Balance Sheet Projects

Fin 46 will be getting a lot more use this year. Fin 46 allows certain non-consolidation based on the original terms of the transaction. However, it also specifies that if conditions change, the tests for consolidation have to be rerun. By design, much (usually 60 to 80%) of the asset values in off balance sheet entities are land investments, either JV's, land banks, or some other form of option. Accordingly, it is these land holdings which will be causing the largest write downs. In similar, but not directly related actions, lenders have been calling for the re margining of loans, which act as capital calls to reduce loan balances at a time when asset values are falling, dramatically increasing loan to value ratios.

Look for a dramatic increase in land holdings and related debt as these assets are brought on to the balance sheets. The best early test case will be LEN as their Nov 30 year end is a month earlier than many of the others. These additions will dilute capital ratios and likely cause covenant violations or amendments. At Jul 30 07 LEN had \$10.5 Billion of assets in the off balance sheet category, 60 to 70% of which was land. And of course we have not discussed the quality and financial strength of the LEN partners/sponsors in these off balance sheet transactions. How many silent guarantees or "Keep Well" agreements are in place to support the project financing. As you look at the speed with which some builders are funding the re margining requests, you can only assume that there is some other form of liability outstanding, otherwise they would be walking from these projects and the related obligations.

It is also important to note that much (if not all) of this new debt will be secured, putting it ahead of the unsecured lenders of a given homebuilder. **The reaction from the unsecured lenders will likely not be pleasant as they figure out that their cash is used to improve the position of the secured lenders.**

Contingent Liabilities

In good times (accelerating sales, increasing margins, high asset turnover) contingent liabilities are minimized and generally ignored in financial statements. In bad times, they are scrutinized much more heavily. Hence the dramatic increase in the size of the 10Qs and 10Ks. We expect an expansion of reporting of contingent liabilities and related loss reserves in the following areas:

Warranty for Construction Defects

This is now more of a risk than in past periods (see Beazer Homes) as home buyers seek a way to cancel sales contracts and recover their down payments. The general perception is that these risks are covered by third part insurance, but they are likely not (see insurance pool comments below).

Liabilities for Improvement Bonds (previously discussed in substantial detail) this risk is growing as municipalities look for ways to shore up their own faltering finances. **Also, the insurance industry (which issues the subdivision bonds) is in its own declining trend, and unlikely to tolerate defaults under the bond agreements, since the municipalities are looking to them to complete required improvements.**

Liabilities for Mortgages Originated to Sell Houses.

There are several levels of risk to the home builders.

Foreclosures on loans held for investment

Put backs from loans sold to investors and pools.

As is becoming obvious, this whole area is now at risk.

Congressmen (and Attorneys General are soon to follow to enforce the wrath of the Congressmen) are going after lawyers, lenders, insurance companies, and bond underwriting companies, along with mortgage originators and appraisers. Look for these defendants to try and shift some of the blame to the homebuilders for the loans originated by these entities and then sold into the mortgage pools. **This is a huge exposure just from the legal cost of defense standpoint.**

Derivative lawsuits from homebuyers attempting
To overturn their original purchase.

Potential Shortfall in Self Insurance Pools.

Most of the homebuilders self insure many of their liabilities, especially in the areas of construction defects, due to the lack of availability of this coverage at a reasonable cost. We have seen a few insurance pools established on the home builder books, but it is not universal. Look for additional loss reserves in this area.

Guarantees, “Keep Well Agreements” and other exposures to JVs, Land Banks, Option Agreements, and Completion Guarantees

As was pointed out in the LEN example above, there appear to be multiple undisclosed forms of potential liability in the off balance sheet arrangements. It is not possible to quantify those exposures on a case by case basis because of the nature of the non-disclosures. However, we have ample examples of large re margining payments to convince us that the practice of making undisclosed credit supporting commitments was pretty universal over the last 5 years.

New Litigation

In times like these there is always a rise in litigation as parties attempt to economically leverage others. Not only is there an increase in costs, there are also attempts to leverage the defendant by attaching assets, etc. The big homebuilders will be the

target of lawsuits from vendors, subcontractors, home buyers, home owners, and current and past joint venture partners and land banks.

Further shareholder derivative litigation is probably a high likely hood. However, we do not feel qualified to comment on the risks in this category.

Cash Flows

Auditors will be looking at more realistic consolidated cash flow models and matching them up to available cash and unused credit facilities. Contingent liabilities will be given a higher level of scrutiny in the cash flows, and will not be assumed away. **For the first time in years, corporate boards may have to look at consolidated cash flows as a guide to land holding decisions and administrative expense levels. Look for some dramatic actions in January and February as the Dec 31 crop of reports crosses the board room table and board members come face to face with their responsibilities and the requirements of their board insurance policies.**

Going Concern Issues

No one is talking about this issue, but it is a real concern for many of the homebuilders. We highlighted this concern last year when we pointed out that these companies were becoming more land investment (as a % of assets and negative cash flows) companies than home builders. **That trend has now accelerated as homebuilding shrinks due to declining sales momentum and evaporating margins. Unfortunately, mandated new investments in land continue due to the requirements of bond districts and municipal governments.**

The conundrum comes into play with the actions of the banks under the credit lines. As each homebuilder has violated (or threatened to violate) the interest coverage or debt ratio covenants, the banks have agreed to waivers in return for reduced loan commitments, **thereby shrinking available credit to meet cash flow needs.** We don't argue that this is a good decision for the banks. However, with fewer home sales and a generally unavailable land sale market (unless sales are made at 25% of book value), cash will soon disappear and additional credit will be needed. **And forget about ramping up construction of houses in a market rebound. Available credit facilities have been invested in land, leaving little or no credit expansion available for new homebuilding.**

Other Observations December 2007

With their collateral rapidly disappearing, what are the Banks and Bond holder groups doing to protect themselves?

By the terms of the credit agreements and bond indentures, these unsecured lenders have no control over the disposition of assets and the subsequent use of cash. **This**

means that every time assets are sold and the proceeds not used to reduce debt the collateral position of the lenders is diminished. Since there is no other source of cash flow, the administrative costs and debt service are coming out of this same shrinking asset pool, or a death spiral. Over the last 5 years there was asset appreciation to cover some of these costs, but that situation is now reversed.

All of this has been very clear for at least 18 months. However, rather than take action under existing covenants (what these covenants were designed for) **the bank groups have chosen to weaken their positions by altering (reducing) or waiving the protective covenants. This has allowed home builder managements to ignore the early warning signs and hold on to large land investments, refuse to write them down to market (mark to make believe) plus keep extraordinarily high levels of overhead.**

The best evidence is the actions of LEN. They refused to take actions early and are now liquidating assets to support their self imposed negative cash flow, all the while impairing the value of the remaining collateral, all at the ultimate expense of the banks/bond holders.

Therefore, the banks and bond holder groups should be asking themselves the following questions:

- 1) Under new accounting standards, **how long will it take the home builders to move to a negative net worth?** The pace will certainly be accelerating.
- 2) **What should the banks do about anticipated requests for new cash, which will surely come?** Under what new conditions would such cash be advanced (or waivers to allow the home builder to get the cash elsewhere)
- 3) **What is the value of the remaining assets in the event the banks are forced into a liquidity crisis?** What are the key assumptions to use in evaluating future cash flows? What discount rates, what management, what costs for development should be allowed?
- 4) **How much in liens and other prior claims on assets should the banks allow to accumulate before taking some decisive action?**

We see these prior claims coming from the following areas:

Senior loans on real estate moved on to the
Balance sheets under FIN 46, necessitating
Debt service from available cash out of the
Unsecured lines.

Liens from unpaid vendors

Liens from defaulted bond districts due to the
Failure to complete improvements

Unpaid Property Taxes
Judgments from losing litigation

- 5) At what point should the banks/bond holders consider asset trades for debt?
- 6) **Should the banks and bond holders consider joining positions?**
- 7) How should the banks respond to a reliable offer for assets from a third party at 25% of book value? At 30% of book value? At 35% of book value.
- 8) What are the good strategies for the banks to maximize their recoveries?

What Would Change Your Mind from Bearish to Bullish

It is always difficult to ascertain when a trend is changing. That is why the home builders are trapped in the current position. It takes some real foresight to look for events which might cause trends to reverse direction. Several of our subscribers have asked us to start thinking about this and to chronicle ideas from different sources. Hence, we are asking you to give this some thought base on your own experiences. Please forward your ideas and I will accumulate them and report back to you on your ideas.