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While the Analysts are Focusing on EPS
They are missing the Largest Issue Facing Homebuilders, Liquidity

Why Homebuilders Will Soon Run Out of Cash# 8
Updated December 10, 2007

Special Report December 10, 2007

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-down's 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 distribute them along with the late February report.

To get things started, I will share 2 things which I have been looking for as a sign of impending change;

3 consecutive months of articles in the LA Times, front page, announcing record actual foreclosures in Southern California. My thinking is similar to the Sports Illustrated Curse, that if this business condition reached the front page of the left leaning LA Times, this would herald the end of the foreclosure cycle. Unfortunately, things have unfolded much faster than I expected, and the LA Times has already reached this benchmark.

3 of 13 largest public homebuilders file Chapter 11 or equivalent (large asset sale to lender group in lieu of Chapter 11). I first thought this might happen in late 2008 but given the speed of decline, it may happen sooner.

Please give this some thought and share your experiences with us. Each of you has had a lot of experience with downturns and subsequent recoveries. What did you see or hear that first told you a change was in the near future. Anonymity will be protected unless otherwise specified.

New Executive Summary at November 01, 2007

Our reports generally rely on the details contained in the 10Q's which are filed by each company, containing a lot more detail than is posited by the press releases circulated at the time of quarterly earnings announcements. **However, the need to get observations out to our readers dictates that we not wait for all of this data, due in mid to late November, at best.** The pressure to increase loss reserves, especially as they apply to land, indicate that some of these reports will be late in filing, and would hold up what appear to be cogent observations based on

the data available in late October. Therefore, we are again moving early to notify our readers of developing trends.

The biggest problem now facing the homebuilders and their lenders/bondholders is their joint failure to take action in prior periods, now resulting in bloated balance sheets and negative cash flow. **This is now a systemic problem, not an individual company issue.** This means they have all held on to massive investments in illiquid land while land values have plummeted, and if they are all forced to sell land at the same time, in the same markets (they all went into the same large markets and gobbled up land, competing with each other to drive the prices up well past buyer house affordability levels), **liquidation values are likely to be well less than 50% of carrying values.** **Who will move first and who will get stuck moving last?** That is the key strategic question for 2008.

Of probably greater import is the deteriorating equity cushion between asset values and the positions of the banks and bond holders. And the quickly fading value of the short term creditors (acts payable holders, there is great risk here, and no one is looking) cannot be dismissed. **It is not difficult to project (see comments below) the loss of all net worth in the coming year** in many of these companies. In anticipation of these deteriorating conditions, what will the lender groups do? How will they evaluate their risk of loss? How will they organize for the probable defaults? How will they interact with the bondholders? How will they deal with asset management once they have taken possession of large pools of assets, as they surely will? To what extent will the auditors force much larger write downs which then impact loan covenants? Will auditors raise going concern issues? Ditto for the bond rating agencies? And finally, how will they deal with the conflicts of interest which will arise as they attempt to reduce investments in one homebuilder at the expense of another homebuilder?

A key question to ponder is whether the government will come to the rescue. There is already a lot of discussion on this matter, with several ideas already being floated. Our conclusion is that government programs (bailouts) will focus on existing homeowners (those that live in the houses, not speculators) with foreclosure exposure resulting in little help for the large homebuilders. Here is our reasoning:

- 1) In an election year it is politically correct to help the little guy but not the speculator
- 2) All the programs mentioned are home mortgage assistance, not land bailouts, which is the bane of the homebuilders
- 3) The size of the CDO (etc) markets is 10 to 20 times larger than the land problem, and the Wall Street types who initiated the CDO type products are simply more politically powerful than the

homebuilders.

- 4) The deterioration of the balance sheets of the homebuilders is well past the recovery stage.

The following observations are based on the press releases and 10Q's which have been filed as of October 28, 2007. These filings cover approximately 85% of the combined income statements and 35% of the balance sheets and cash flow statements, so they are considered fairly predictive of the universe. Further variations are likely to be more negative, not positive.

New Trends and Deeper Results of Previously Identified Negative Trends

- 1) This year's Q4 cash flow will be much worse than prior years because HBs won't have big sales in Q4 (see reducing new orders, shrinking backlogs, and increased cancellation rates). This will stress cash availability over next 12 to 18 months...
- 2) Admin costs are still not coming down materially. Everyone seems to be holding on to personnel expecting a market turnaround in 2008. Further stress on cash flow.
- 3) While stock buybacks have been materially reduced, some companies are still spending dear cash for dividends. Not wise, and some of the credit agreement amendments are now cutting back on this activity.
- 4) **The number of active selling communities staying high with new ones started in 2007 and old ones not closed out.** This is a big drain on carrying costs, admin costs, marketing, and market risk to building inventory as sales prices continue to deteriorate. Variable costs of construction are not being recovered as net sales prices drop.
- 5) Getting close to bigger write downs **as auditors put pressure on NRV calculations with yearend audits.** Ignored by the auditors over the past 4 years, home builders are now zeroing in on carrying values and related going concern issues. **Look for delays in publishing 10Ks as companies negotiate with auditors appropriate adjustments to book value,** especially of land. **Our NRV model suggests that all land holdings should be carried at less than half of historic cost, and existing housing inventory should be written down by at least 20%.** This level of write down, if adopted by each company, could cause significant challenges under credit agreement covenants regarding net worth maintenance.

Of equal import will be the impact on operating statements. During

the past year, as land write downs have been adopted, homebuilders have continued to capitalize land carrying costs, thereby inflating quarterly operating earnings. This contravenes accounting rules and common sense; if the project is going to be a loser, then current carrying costs should be expensed. **Homebuilders and lenders will be scrambling to review interest coverage covenants to determine if they need to be adjusted to account for this change in circumstances. This is where operating earnings will match negative cash flow, and the horrendous operating condition of these companies will be exposed.**

Large quarterly operating losses, coupled with additional large write downs, will cause net worth to zoom towards zero, and in some cases, dive below zero.

- 6) It is amazing that after the big write downs, and knowing that more is coming, that the companies continue to capitalize interest and other carrying costs. Look for this to change at year end, with major hits to operating earnings. Operating earnings will decline materially in the years ahead as carrying costs are added to declining sales volume at much lower prices/margins.
- 7) **There continues to be no major land sales, meaning negative cash flow to continue, leading to more write downs.** Homebuilders have all played a dangerous game of holding land rather than admit to land write downs. Now they have the write downs, and still have the land and associated negative cash flows. Some, like Lennar, continue to try and play games with cute transactions in an attempt to hide the large size of the problem, only to have market forces come back and make the problem even worse. Auditors will be forced to deal with this lack of land sales in establishing disposition values after extended holding periods. After the auditors look at the universe of residential land now available for sale (which we estimate at \$125 to \$175 Billion) they may conclude lower disposition prices than even the most pessimistic homebuilder.
- 8) Bank groups have been putting band aids on credit agreements, hoping conditions would soon improve. Covenants have been removed or waived to not face deteriorating conditions. **2008 will see major revisions to credit agreements, reducing loan amounts available, and holding the line on covenants so that bank collateral and security positions are not placed in jeopardy. Confrontations with homebuilders will rise as cash availability is diminished further by reduced home sales. Bank groups will be forced to confront**

insolvency situations, facing large amounts of unsold housing inventory and very large land tracts.

- 9) Homebuilder sales have been fueled by easy underwriting of home builder captive mortgage companies. In the past these loans were quickly sold for 100% cash in the secondary market. **Sales of these mortgages will be sharply curtailed as the subprime climate makes these loans too risky for many buyers. This will inflate balance sheets and crimp cash flow as builders are forced to keep these mortgages.** Unless mortgage lines of credit are expanded, which looks unlikely, this will hurt sales.
- 10) **Tightened cash flow will force most companies up against definitional problems in borrowing base calculations.** In most credit agreements, land is a much less desirable asset class, and its collateral value is therefore reduced. Consequently, as some houses are sold, the full amount of the loan cannot be re borrowed under these definitions. This may be where the companies are forced to sell land at distressed prices.
- 11) As suggested in earlier versions of this paper, **re margining of loans in joint ventures and land banks is now accelerating and forcing capital calls and other cash infusions into more illiquid land ventures.** These cash drains will continue unabated (and will likely accelerate) until significant land inventories are liquidated. **There will be some defaults by partners, forcing more of these ventures directly on to the balance sheets of the homebuilders, further testing loan covenants.**
- 12) **Sales velocity continues to deteriorate in spite of lowered sales prices, increased incentives, and multiple national sales programs, like Hovnanian, Lennar, and Standard Pacific.** This decreased momentum is reflected in lower new sales levels coupled with increased cancellation rates. New sales are lower than closings which have already fallen by 30 to 50% from similar periods last year. As pointed out earlier, **this reduced sales level will result in much greater pressure on cash flow as the traditional 4th Quarter push for closings (usually accounting for 35 to 40% of annual closings) does not have the backlog to generate these sales.** The HB companies have continued to build inventory in anticipation that all backlog sales will be completed, but that simply will not happen.
- 13) Drying up of secondary mortgage money makes absorption levels likely to continue dropping. **Large losses now being experienced by**

major financial institutions, both domestic and foreign, will cause these investors to stay out of this investment type for some time to come. Therefore, mortgage funds will continue to shrink, depriving the homebuilding industry of one of its most important raw materials. Look for this negative impact to stay in place for at least 3 years, and more likely 5 to 6 years. 2005/2006 absorption levels coupled with premium asset pricing will not return for at least 10 years.

14) **Senior secured improvement bonds will start to become a major issue. These instruments are prior to all loans like property taxes.**

Most of these instruments provided for a 2 year interest reserve. With absorption stretching out past this time frame, property taxes will be increased to provide for the collection of interest on the bonds. We have no direct evidence of the size of this problem, but given the rate of land development during 2005, 2006, and 2007, **this could be a \$10 to 25 billion loan problem.**

15) We generally do not address macro economic trends but feel compelled to comment on two which will impact housing over the next 12 to 24 months.

A) Overall employment has remained high through the difficulties experienced to date. Layoffs in the real estate related industries are now being joined by significant cuts in banking and financial services. **At some point soon negative employment trends will exert additional downward pressure on home sales and pricing.**

B) **Today's real estate crisis has happened in a period of relatively low interest rates.** Discussions of further rate cuts will likely be accompanied by higher unemployment, and are therefore unlikely to lead a turnaround in the industry.

Athalon has recently entered into a venture (Black Swan Partners) with Developers Research (DR) of Newport Beach to provide homebuilder portfolio evaluation and cash flow reviews. We have a combined 50+ years of experience in the homebuilding and land development businesses, covering 5 previous residential downturns. **This venture has the capacity to provide project by project evaluations on 300 to 400 projects,**

including 5 year cash flows, within 60 days. The specialty of this venture is the evaluation and cash flow analysis of large land parcels. We also retain the ability to generate consolidated cash flows, by quarter, of all the individual project valuations and cash flows. Further services include cost to complete evaluation, zoning and land use review, title review, and alternate land use/alternate valuation analysis. Please contact me if you feel we may be of assistance in reviewing any portfolio in which you have an interest, or may have an interest in the future.

New Executive Summary at July 30, 2007

In June, 2005, we published our first outlook for the US Homebuilding Industry. **At that time** we foretold rapidly declining home sales, cash and credit shortage, and stock prices for most stocks under 10 by the end of 2007. Those conclusions were based on a review of all available financial statements coupled with 35 years of experience in the homebuilding and land development business. We also developed an industry cash flow model which has proven quite accurate. Fortunately for us, the direction and timing of our assessments turned out to be pretty accurate. We are not trying to brag; we are trying to get the reader's attention that our cash flow model has been fairly accurate, especially as it is applied to our 2007/2008 projections which follow. These are not idle observations.

Now the third leg of that stool is in the process of falling, the severity of the decline. **Based on the conditions extant in June, 2007, it now appears that the fall will be much deeper than originally anticipated.** This additional severity is being caused by the rapid (and unanticipated) withdrawal of mortgage credit brought on by the phenomenal increase in residential loan defaults and foreclosures, which in turn have decimated the securitized loan market. (Remember, the securitized loan market replaced the S@L's as the primary source of mortgage credit for the past 10 years) **The speed with which these events have unfolded has exposed significant structural defects in the secured loan market (including the possibility of over leverage, fraud, and generally poor structuring for a rapidly deteriorating market).**

Events are unfolding so fast it is not possible to keep up with them on a daily or weekly basis. Therefore, we have decided to provide our guesstimates as to how events will unfold over the next 6 to 12 months based on the review of current financial statements (individual and consolidated through June 30, 2007) coupled with the experience of having gone through 5 prior real estate down cycles. **It is also based on our consolidated industry cash flow model which has guided our thinking over the last 2 years, which model has been unusually prescient in calculating the severity of the downturn. The over all conclusion is that this**

down cycle will be far deeper than 1991/1995, and its impacts will be far greater due to the much greater amount of leverage provided at the late part of the up cycle (read lots of high loan to value loans at peak prices, especially land). The following observations are coupled with expected results, which in our review have an 80 to 90 % probability of occurrence.

- 1) **Cash and new credit availability will continue to deteriorate.** This comes from declining home sales volumes at ever shrinking margins, coupled with the ever voracious cash requirements of land development (see more below). The failure to sell land when there was a market 12 months ago is also a major contributor.

Of major note, while the industry is supposed to be in a state of consolidation and reduction, combined balance sheets show little reduction, with only a small increase in cash and a small decrease in total debt. More alarming, the investment in houses under construction has shrunk while the investment in land (and joint ventures) has increased, which means more working capital is now tied up in very illiquid assets.

- 2) The improvement bond and LOC footnotes provide a fair proxy for approximately 50% of the capital required to complete land improvements for land already owned. Once started (including the issuance of bonds), these improvements cannot be easily curtailed without the consent of the issuing municipality and bonding company. **The 13 largest public companies report an estimated \$15 billion in improvement bonds and LOCs. This means there is about \$30 billion of remaining work to be done on the existing owned land.** (It is difficult to tell from the footnotes, but it appears to not include land held in JVs and unconsolidated subs, so the actual liability is likely much greater. This is especially true for a company like Lennar where there is \$10.5 billion of off balance sheet holdings, much of which is land). Unless stopped, this money will have to be spent over the next 2 years unless those land parcels are liquidated.

- 3) The rapid decline in house sales prices to approximately 2004 levels means that most land parcels acquired in 2004 or later have virtually no land value (remember that the 2004 actual house prices are for houses built on lots acquired in 2002 or earlier at much lower land

costs). With the debacle in the Subprime and CDO markets there is unlikely to be a mortgage climate similar to 2004/2006 for another 10 years, and therefore there will not be the sales volume velocity to achieve the high level of house prices either. Consequently, booked land values are likely only 30 to 50% of current book values, meaning substantial additional book losses as land is sold. **However, it also means that land will not be a source of cash to meet negative cash flow needs, except that the liquidation thereof will relieve the respective company of future negative cash flow requirements.**

Our NRV model indicates that land costs should be written down by a minimum of 40 to 60% based on early 2007 absorption levels. If sales rates continue to decline, these adjustments will go up.

Of possibly greater import, look for the auditors to start demanding greater levels of write downs. To date, homebuilders (in doing their NRV calculations) have been assuming a rebound 6 to 12 months out, with sales rates returning to 2006 levels and prices and margins also set at 2006 levels. This allows them to keep from declaring a loss on the project and thereby establishing a writedown. With no writedown, project carrying costs continue to be capitalized, substantially inflating EBITDA. When the auditors demand more write downs, more charges will start to be expensed, further impacting income statements at a time where revenues are also declining. **Therefore, debt service coverage ratios will continue to implode.**

In support of this observation, it should be noted that for Q2 new sales were at lower levels than closings and that average sales prices for new sales were lower than for actual closings (given the large sample size we are using it is unlikely that this is an aberration). And this was for the strongest part of the selling season. With all the bad press it is likely that cancellation rates will continue to increase, and will not go down. **Therefore, as the industry moves into the slower winter selling season, absorption rates will continue to decline, negative cash flow will continue to accelerate, and with the approach of year end, land write offs will likely explode to the up side.**

So far, lenders have been adjusting covenants to accommodate these deteriorating conditions in the hopes there would soon be an industry turn around. **Look for the lenders to start toughening up as they realize how imperiled these companies are.**

- 4) **It is apparent that all of the homebuilders and their lenders are in shock and denial.** No homebuilder has initiated a major land reduction program for owned land (they have made a lot of noise about giving up land options, but not much activity on actual land sales), and all of the lender groups continue to relax covenants, thus enabling the homebuilders to not bite the bullet until things get much worse. Given the facts now unfolding in the industry, it is unbelievable that lenders continue to allow negative cash flows for stock repurchases and dividends. Our real time research shows that homebuilders are rebuffing potential land buyers by telling them that if sales are not for book value they will not sell. This means that the homebuilders are holding on to land in a rapidly declining market, and when they are all forced to come to market in 2008 to meet cash requirements, they will collectively push the land market down even further. Remember, our estimate is that there is \$100 billion of residential land available for sale (intentional or unintentional) held by the public and private large homebuilders, most of it acquired in 2005/2007. **Notices of default on land loans have been accelerating over the last 90 days as interest reserves are depleted.**

Further evidence of a failure to take action to improve cash flow is the meager level of G&A expense reductions. Companies continue to hold on to corporate personnel, and to give them enriched contracts, in spite of the evidence of a rapidly shrinking industry. This is a cash flow matter. **No one is acting like there is any risk that cash or credit might be curtailed.**

- 5) **The much heralded impact from mortgage resets is largely misunderstood in the press and the investing public at large.** The consequences are much greater than projected. While \$500 billion or so have already reset, these resets have generated the default and foreclosure rates recognized to date (now running at 160,000 new filings per month). There is about another \$1 trillion to be reset in the next 12 months. However, most loans require additional resets each 6 or 12 months, so the foreclosures resulting from the first wave are not yet done. Look for the foreclosure rate to exceed 200,000 per month and stay at that level for at least 12 to 18 months.

It is also a misconception that foreclosures are a result of poor underwriting. **What is causing the stress is the size of the mortgage payment increase (going from 2% to 6%), which effect is cumulative every month.** With no refinancing possible for most of these borrowers, and with incomes increasing only moderately, the borrowers have few options. It is also now being well reported that Alt A loans have a higher delinquency rate than the Subprime loans, further evidence that it is the size of the increase in monthly payment which is the problem.

All of this will guarantee a continued supply of new for sale houses on the market for at least 12 to 18 months, and unless there is a wave of investors picking up these houses as investments, they will remain on the market competing with other foreclosures and non foreclosures for a shrinking pool of legitimate buyers.

- 6) **A major critical error was made by all of the public homebuilders in late 2006 when they assumed a recovery in the industry in 2007 and ramped up 10 to 15% more active communities during early 2007.**

This means that approximately 400 to 500 new projects were brought to market earlier this year. On the front end, new projects are voracious cash eaters, for model complexes, more spec houses, and extensive marketing expenses to get the project off the ground. With the market continuing to implode this will result in another major slug of capital being buried for an extended period of time.

Because we are located in So. California, the best examples we have are situated here. There are two examples of companies saying one thing and doing another in this area.

Lennar has been stressing how they are reducing inventory, but look at the attached picture of the Central Park West project in Irvine, Cal. Almost 1400 new units have been started in this project since the beginning of 2007. All the market evidence is that this sub market is extremely overbuilt in the product types being built by Lennar, and there is already significant price pressure. Reading this market data, who would start all 1400 units at the same time?

Standard Pacific recently started sales on a 39 unit subdivision in Irvine Coast where the average sales price for these tract houses is \$7.5 million each. That's \$240 million of construction product, or

more than 25% of their WIP.

In both these cases (as well as many others around the Country), the perfect time to stop construction was in early 2007 before foundations were poured. Both companies choose to ignore all the evidence to the contrary.

- 7) **The nature of the balance sheets have changed materially over the last 2 years, with a much higher level of land investment (and getting more so with the land development expenditures) relative to housing inventory which can be more easily liquidated.** These are now land development companies more than they are housing construction and marketing companies, and should be treated as such. **A highly leveraged land company has a much higher risk profile in a recession than does a housing company.**
- 8) Complicated, highly structured, highly leveraged arrangements seldom have positive outcomes during a severe downturn. Based on our experience in 5 previous residential real estate recessions, **look for some or all of the following (to some, Black Swan type events) to arise out of the off balance sheet arrangements for projects which have been out of site of the auditors for the last 5 years;**

Heavy capital call requirements on the public homebuilders as land banks and joint venture partners are unable to meet the cash requirements of holding and developing large land parcels. Even if it is not their responsibility according to the documents or reports, look for undisclosed side agreements and guarantees (or as alleged by the partners/land bankers) to provide further financial support or loan guarantees.

A variation of this problem will be the forced booking of land interests as the capital position of JVs and Land Banks change with declining land values. Several different things will begin to happen:

Assets and liabilities will move on to the balance sheets of the homebuilders.

New write downs will be dictated as a result of the bookings.

Debt structures will start to change as these off balance sheet projects have a much larger percentage of secured debt at higher loan to value ratios. The assumption of this debt will push the envelope of debt to equity ratios and could very well trigger covenant violations.

One of the best examples is to review the Lennar footnotes to the Financial Statements for May 31, 2007. Their footnotes disclose that their \$1.25 billion investment in JVs and Unconsolidated Subs is really an investment in \$10.2 Billion of real estate projects, 80% of which is land. Only a small writedown has been taken so far, and there is \$5 Billion of debt. There is no disclosure of the financial capability of Lennar's JV partners or land bank entities. Look for significant problems for Lennar in this area.

Lots of partner initiated litigation as poorly capitalized development partners try to leverage their public company counter parts for payoffs for disengagement.

Heavy cost over runs as little attention has been paid to the details of these transactions as management was delegated to the joint venture partner/land bank operation.

Misunderstood title and zoning entitlements. Again, lack of proximity to what was really going on means surprises to the ultimate risk holder. **Don't be surprised if there are also major title challenges.**

Rapidly declining land values as more attention is paid to on the books projects, leaving action in the hands of the venture partner, who is not motivated to sell until absolutely necessary.

Mortgage Origination Liability. Almost all of the homebuilders had captive mortgage operations, which made loans mostly to their own buyers but also to outside buyers. There will be two types of liability, not unlike that experienced by New Century types of lenders

As defaults and foreclosures increase, borrowers are

aggregating into class action groups to assert defenses. At the same time, Congress is looking for someone to blame for all the foreclosures and troubles in the CDO/MBS markets, which are going to be huge. Ultimately, the responsibility will be pushed down to the originator. Over the past 2 years, if there was a choice by the homebuilder to keep a house in unsold inventory, or sell the house to a financially unqualified buyer (and then sell the loan off into a CDO/MBS), you know what choice the homebuilder would make, assuming there was little or no recourse liability.

Outside buyers will look for similar relief and may look to join these class action groups.

Warranty Liabilities. Likewise, there was a lot of pressure to get closings completed, even if the home was not properly finished. Class action groups are starting to look at this issue as a defense against foreclosures. You can see in the warranty reserves that the homebuilders now realize that they are under reserved and are starting to make blanket additions to the reserves, and are adding to the per unit charges.

Insurance Liabilities The homebuilders started expanding at a time (late 1990's) that insurance was difficult to obtain. Therefore, they began self insuring many of their operations. This means that the aforementioned class action liabilities, and other warranty type risks, are self insured. Could be major.

The above observations do not paint a favorable picture for equity holders, lenders, bond holders, or joint venture partners. **Without a major bailout from the federal government the homebuilding industry will continue to decelerate well into 2008.**

We now expect a major liquidity event to imperil 3 of the 13 largest homebuilders before June 30, 2008. This may include Chapter 11 filings.

Athalon Properties is currently providing portfolio guidance (including detailed quarterly cash flows) for large residential packages, both for lenders and acquisition groups. Athalon has the capacity to provide detailed cash flow analysis on a project by project basis for up to 750 projects within a 60 day period. Athalon can also provide its detailed individual company or consolidated industry financial statement analysis.

For additional information on these services, please contact the writer at the number and or email address provided above.