



# A Morning After: Can Big Public Homebuilders Turn Excess Into Success?

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## 4 Other "C"'s Other Than "Cycle"

Today We'll Address . . .

- **CAPACITY**
  - Excess new unit and "store" count is beginning to diminish
- **COMPETITION**
  - The hyper-competitive public industry structure compounds cyclical excesses and is likely to mute recovery compared to the past
- **CONSOLIDATION**
  - Barriers to M&A are both financial and psychological. We see the **OPPOSITE** for most: re-fragmentation and re-regionalization
- **CHANGING BUSINESS MODELS**
  - De-emphasize cycle-specific drivers like unit growth rate and land margin
  - Emphasize business-specific improvements like asset efficiency and consistent cash generation
  - Result: potential industry rationalization (and hope for eventual share price expansion for the big public builders)

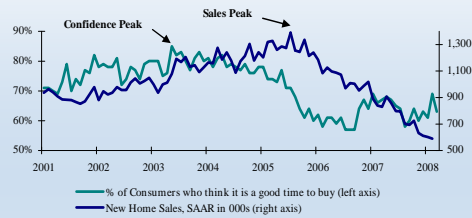
# Some Quotes from CEOs

The Behemoths Aren't Very Positive

- During some recent management visits, here's what some CEOs said:
  - “Every day I look at myself in the mirror and say, ‘If I hadn’t been so greedy, I wouldn’t be in this mess.’”
  - “In some markets, there is no price elasticity. We’d need to drop home prices 50% to return [unit] sales to normal.”
  - “This downturn has another three years to go. We won’t recover until 2011, and that’s how we are running the company.”
  - “The Fed and GSE reform are too late. We needed to do this six months ago. Now my selling season isn’t likely to be strong.”
  - “The time to buy land is when no one thinks real estate will ever recover again. And no one’s children thinks it. And no one’s grandchildren thinks it.”
- But another said:
  - “I’m private so I’ve always had to run my company for cash. That’s what the owners demand. They always want to know how big their dividend checks are going to be.”

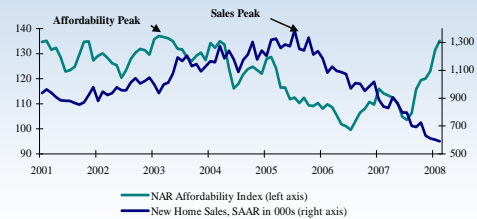
# Our “Speculator Replacement”

Theory Beginning in 2003, A Disconnect Among Sales, Consumer Attitudes & Affordability



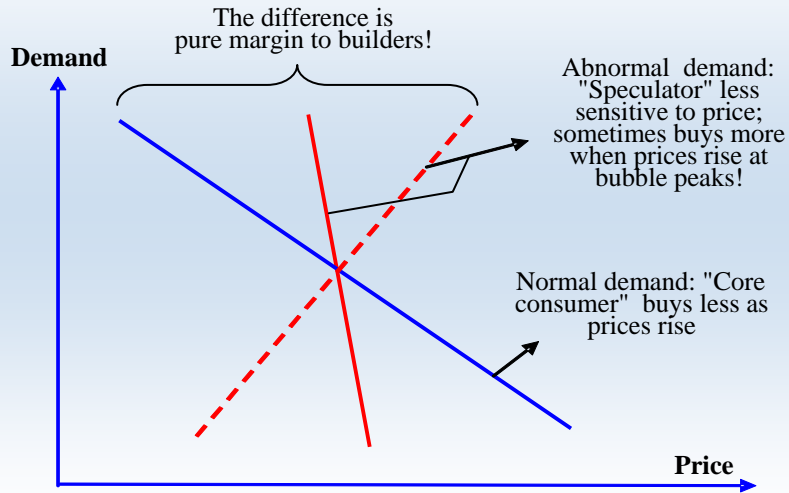
Percentage of consumers who believed it was a “good time to buy” peaked in early 2003, yet sales peaked two years later

Likewise, affordability peaked two years prior to sales. What caused this odd divergence from common sense?



# Our "Speculator Replacement" Theory

Culture and Mindset Changed! Speculators Are (Were) Much Less Sensitive to Price

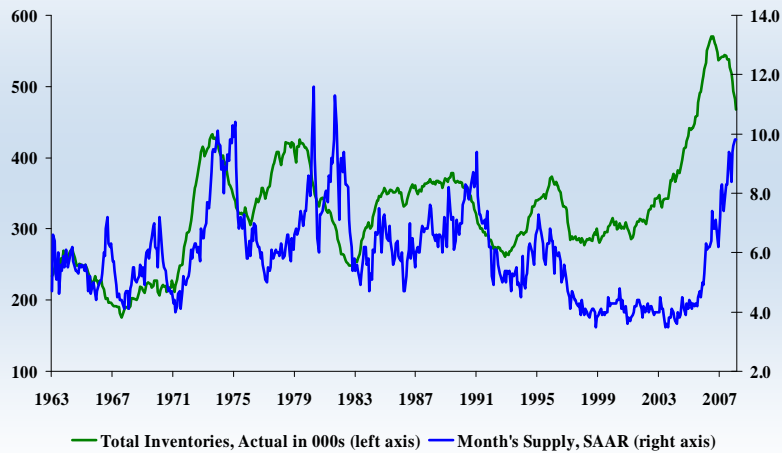


Source: Wachovia Capital Markets, LLC  
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# Inventory: Optical Confusion

Unsold Inventories Have Crested; Months' Supply May Not Have

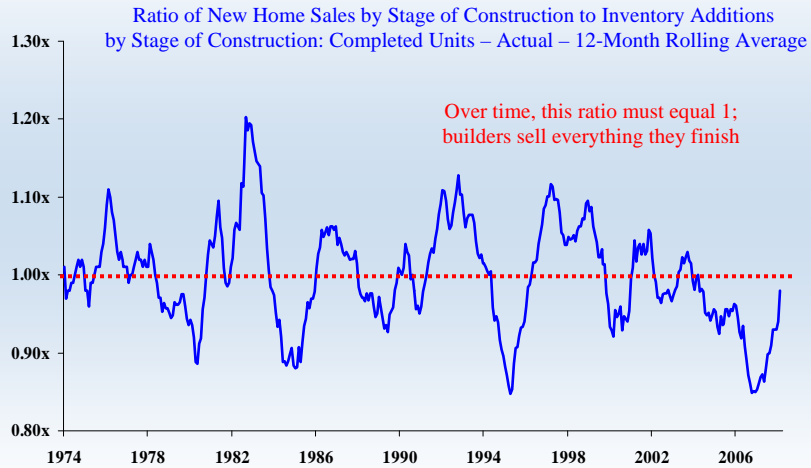


Source: US Census Bureau  
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# “Overbuilding” About To Reverse?

Builders Finally Matching Finished Goods Completion With Finished Goods Sales

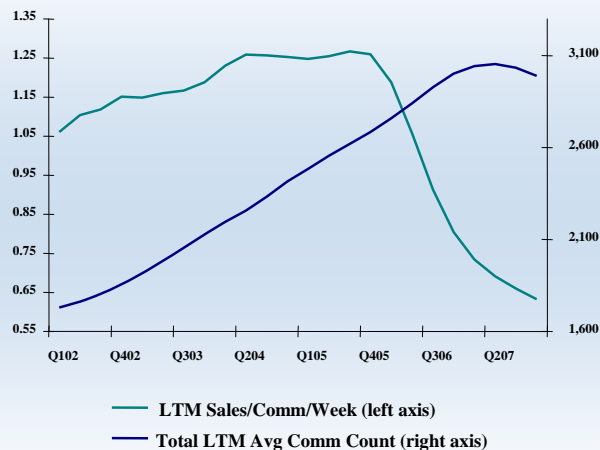


Source: US Census Bureau  
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# Large Builders Still “Overstored” . . .

Little Reduction In Community Count Though Sales/Store Off 50% From Peak

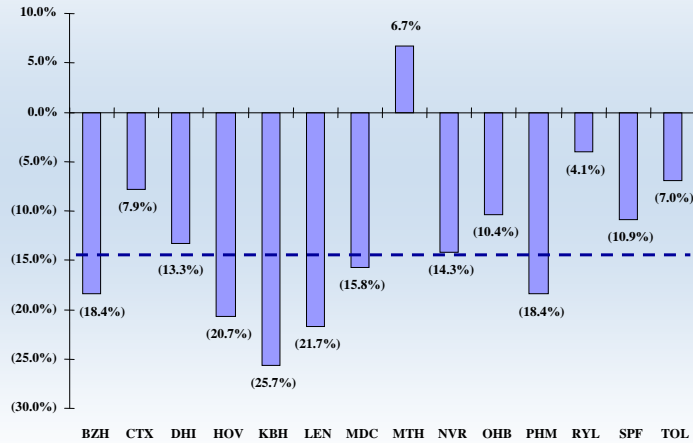


Source: Wachovia Capital Markets, LLC and Company Data  
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## ... But Finally Reducing Outlet Count

Change In Community Count – 4/30/07 to 3/31/08



Source: Wachovia Capital Markets, LLC and Company Data  
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## Hyper-Competition

Secular, Organic Growth Story Is Much Closer To Over Than Many Think, In Our View

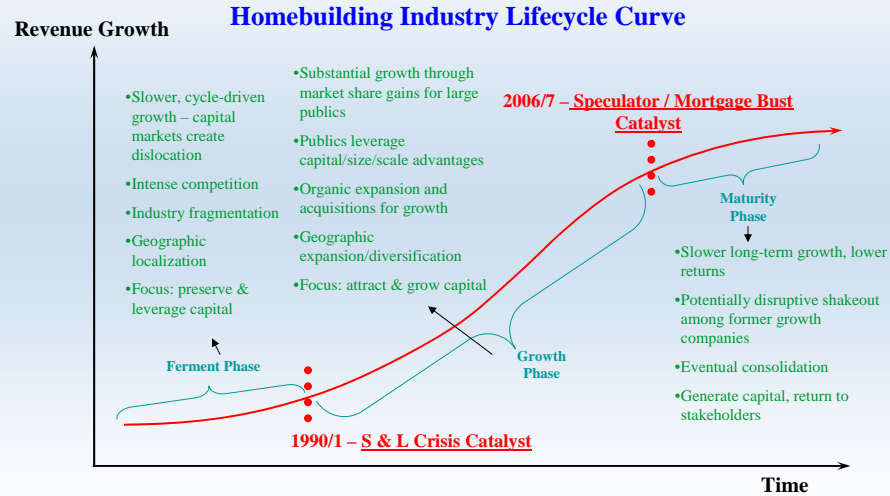
- **Cyclical support unlikely to be nearly as strong – the “perfect calm”**
- **The battle for market share among publics turned Pyrrhic as the cycle flipped**
  - The largest builders now compete with each other in nearly every major market
  - National share for top 20 went from 10% in 1992 and peaked at 26% in 2006, by our count, but . . .
  - Share was 40-50% for the top 20 in 5 of the top 10 U.S. MSAs by permits in 06
- **NOT like the last downturn, in our view**
  - S&L crisis left capital in the hands of relatively few publics (who were smaller and more regional at the time than now) while decimating the private side
  - Publics levered access to and low cost of capital to grow 2x industry rate in the 1990s and early 2000s
  - Now, competitive dynamic is public v. public on a more level playing field
- **Competitive rationalization hard to forecast**
  - “Merge, die or shrink” are today’s options
  - Widespread acquisitions/bankruptcies seem unlikely in our view; default choice is to step back and re-concentrate on core markets for now

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# Moving From Growth To Maturity

Large-Scale Tract Homebuilding, Like Any Industry, Has A Lifecycle Curve

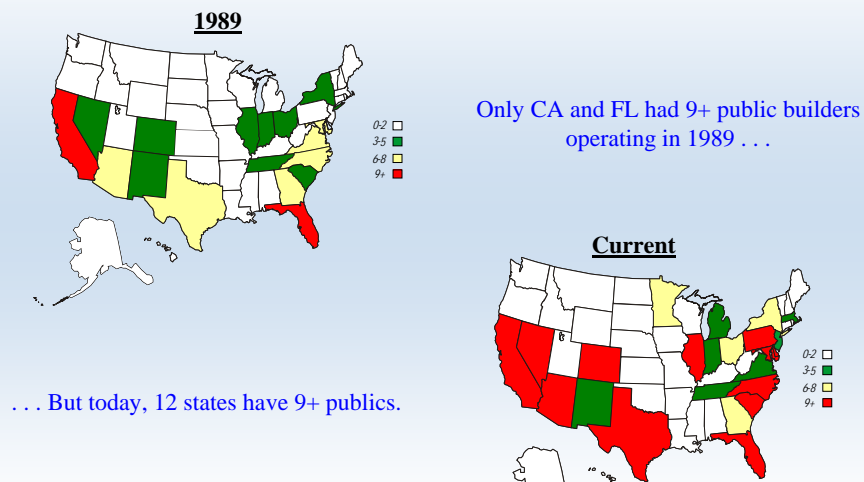


Source: Wachovia Capital Markets, LLC  
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# Is Everyone Most Everywhere?

Public Builders Have Greatly Expanded Their Territory Since 1989

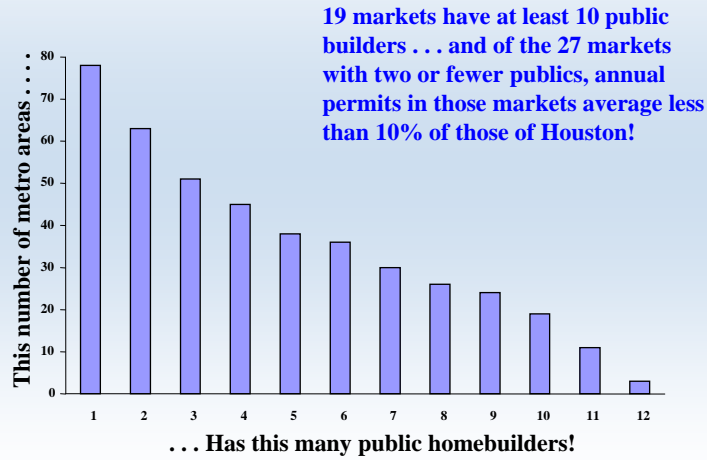


Public Builders per State  
Source: Builder Magazine and Wachovia Capital Markets, LLC  
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## A Public v. Public Battle Nationwide

Of the 78 Metros The Top 13 Builders Occupy, There Are More Than 6 In Half Of Them



Source: Wachovia Capital Markets, LLC and company information  
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## Better Risk Profiles Than Last Peak

Will The Survival Of All Forestall A Classic Darwinian Evolution at Market Bottom?

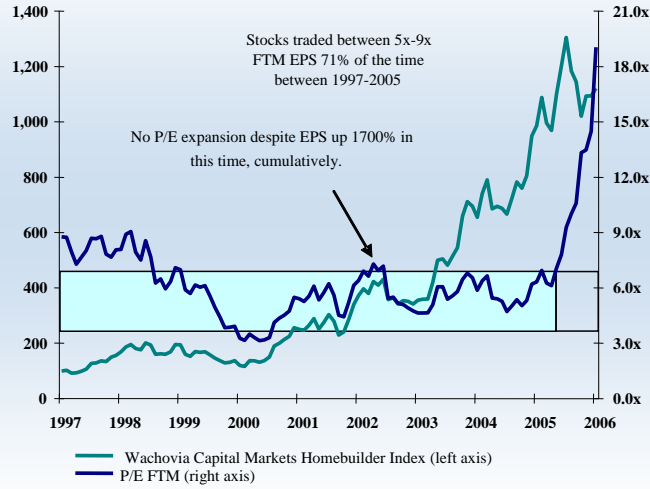
	Our 13 Builders	Our 13 Builders
	<u>1989*</u>	<u>2005</u>
Debt/Capital	69%	42%
LTD/Inventory	1.29x	0.44x
Assets/Equity	6.88x	2.72x
Sales/Assets	0.54x	1.87x
Land Option Usage	27% optioned	55% optioned
Average Number of States	6	18
National Market Share	3.4%	21.3%

\*Excludes BZH, DHI, MTH and OHB  
Source: Company Data and Wachovia Capital Markets LLC  
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# Big Publics “Unrewarded” For Growth

Earnings Soared, But Wall Street Didn't Accord Builders Higher P/E Ratios!

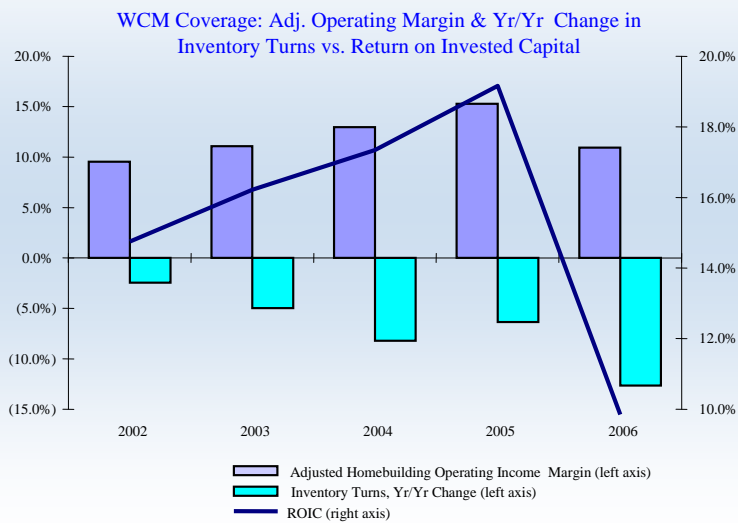


Source: FactSet and Wachovia Capital Markets, LLC  
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# Margins, Not Turns, Drove Returns

Very Few Industries See Expanded Return On Capital With Inventory Turns Falling

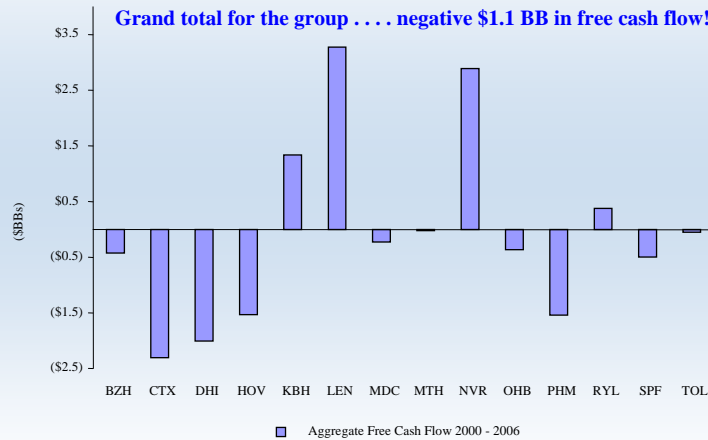


Source: Company and Wachovia Capital Markets, LLC  
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## Cash Flow Reinvested Into Land

Only 4 of 14 Public Builders Were Free Cash Flow Positive From 2000-2006



Source: Wachovia Capital Markets, LLC and company information

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## Competitive Rationalization, Anyone?

Barriers To Public-To-Public M & A Are Numeric, Cyclical And Psychological

### ■ The problems

- 80-90% variable cost business – little synergistic cost leverage/savings
- Land overage already – most publics already long more lots than needed near-term
- Current valuations – “cheap” but difficult to pin down with excess writedown risk
- Capital availability for transactions has compressed (dramatically)
- Pricing power – modest consolidation won’t achieve more disciplined pricing
- “Already everywhere” – many publics already national; fewer “regionals”
- CEO barrier – comp packages substantial, entrepreneurial founders reticent to let go
- “If I can’t value my own land, how can I value someone else’s?”

### ■ Having said this, we could see (and have seen):

- Asset pick-ups in truly distressed markets
- Take out of “problem” companies (public and private)
- Fee deals as banks regurgitate land
- Deals done off-balance sheet

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# Competitive Rationalization, Anyone?

Private Equity Or Strategic Acquirers? Perhaps

- **Private Equity? Paradoxes complicate the analysis**
  - Land is both a fixed asset AND a variable one – inventory IS the factory
  - Capital intensity is high – must shrink business (or grow slowly) to generate cash
  - Valuation timing – in 10 years, equity yields have only topped 10x in downturns
  - “Land fund” capital appears to be accruing to “tabula rosa” managers and managements
  - We believe IRR requirements are very high
  - Allegedly 100+ firms with over \$10 BB
- **LBOs/MBOs?**
  - Capital now highly constrained; the window has closed
  - Leverage ratios already modest-to-high in many cases
  - Would an in-place CEO cut off the equity avenue in a capital-intensive business?
  - Will entrepreneurial founders work for someone else?
- **Offshore interest?**
  - U.S market offers population growth, well-developed mortgage industry
  - Timing good – U.S. cycle depressed, more reasonable book valuations
  - Possible suitors: international builders, global R.E. firms, industrial conglomerates
- **But none of this necessarily helps an “over-built” environment**

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# Beyond the Cycle: What’s Next?

Secularly, We See A PERMANENTLY More Competitive Environment For Publics

- **Growth**
  - Market share gains hampered by “public v. public” battle among the “walking wounded”; in our view, more likely we will see “shrinkage” than share gains
- **Margins**
  - Speculator, EZ-finance drivers gone for the foreseeable future
  - Land price compression unlikely to be permanent if most well-capitalized builders survive or if land funds feel pressure to invest
  - Materials prices subject to exogenous pressures; labor prices likely to fall and remain nominal
- **Returns**
  - Clearly driven by margins 2000-06
  - Unless builders can boost asset turns through off-balance sheet land control or become MUCH more construction-efficient, ROE & ROIC likely to remain depressed relative to history

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# Our Polly-Anna Utopia: A New Model

Public Builders Should Balance Growth With Cash Flow Generation

- **Public builders must become cognizant that:**
  - Homebuilding's industry structure is mature and hyper-competitive
  - Growth, margins and returns are unlikely to have the cyclical or secular kick the 1992-2005 period provided
  - Wall Street didn't believe earnings hyper-growth was sustainable (hence the low P/Es)
  - Wall Street will pay for consistency of a growth rate, even if modest, and return of excess capital
- **To maximize shareholder value, builders should:**
  - De-emphasize cycle-specific drivers like maximum unit growth and land margin which aren't always in a builder's control
  - Emphasize business-specific improvements like cycle times, pricing for asset efficiency and consistent cash generation
- **Such a strategy might include:**
  - An intense focus on reducing aged assets, today and permanently
  - A balance between market depth for scale and a geographically- and demographically-diversified profit stream
  - A clear road map for much more efficient manufacturing
  - A policy of reinvestment of excess cash into regular share repurchase, maintenance of low leverage and higher dividends
- **We believe the outcome would be:**
  - Slower growth rates, but more predictable earnings and cashflows
  - Long-term, higher price/earnings and price/book multiples

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# Price-to-Book Valuations: Tempting?

Price/Current Tangible Book For Our Coverage Universe (Average, Equal-Weighted)



Source: Wachovia Capital Markets, LLC and FactSet

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## Stock Prices and Ratings

	Rating	4/21/08 Price
BZH	2 / V	\$10.20
CTX	2 / V	\$21.12
DHI	2 / V	\$16.64
HOV	2 / V	\$11.62
KBH	2 / V	\$24.40
LEN	2 / V	\$18.33
MDC	2 / V	\$45.20
MTH	2 / V	\$20.00
OHB	2 / V	\$5.01
PHM	2 / V	\$14.59
RYL	1 / V	\$33.91
SPF	2 / V	\$5.41
TOL	2 / V	\$23.76

1 - Outperform, 2 - Market Perform, 3 - Underperform, V - Volatile

Source: Wachovia Capital Markets, LLC estimates and FactSet

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