3D ADVISORS

This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
✓ **Governance:** Corporate Governance Issues

Governance Behavior In Several Areas is Suspect NVR, Inc. (AMEX:NVR)

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NVR, Inc. operates in two business segments: homebuilding and mortgage banking. NVR conducts its homebuilding activities directly and its mortgage banking operations primarily through a wholly owned subsidiary, NVR Mortgage Finance, Inc. (NVRM). The homebuilding segment is a homebuilder in the United States and in the Washington, D.C. and Baltimore, Maryland, metropolitan areas, where the Company derived approximately 56% of its 2002 homebuilding revenues. NVR's homebuilding segment primarily constructs and sells single-family detached homes, townhomes and condominium buildings. The mortgage banking segment is a regional mortgage banking operation. Substantially the entire mortgage banking segment's loan closing activity is for NVR's homebuilding customers. NVR's mortgage banking business generates revenues primarily from origination fees, gains on sales of loans, title fees and sales of servicing rights.

Summary of 3DAdvisors Findings for NVR

- **Accounting:** Company spends most of its cash on repurchases
- **Insider Trading:** Insiders are taking advantage of inflated prices
- **Accounting:** Option exercises generating huge tax benefits
- **Accounting:** Company pulls out all the stops to increase repurchases
- **Governance:** Behavior in several areas is suspect

Discussion of 3DAdvisors Findings

One of the most secretive companies we've run into over the years, NVR, Inc. does not conduct earnings conference calls; has a founder, CEO and largest stockholder that does not grant interviews; has limited analyst following on Wall Street and provides limited, bare-bones disclosure in its financials. One of the few analysts following the company tells our contacts that they rarely are able to have conversations with the Company. In the Regulation FD and Sarbanes-Oxley era, this very stingy disclosure behavior by itself gets our attention, and it's just the beginning. Extensive stock repurchases that inure to the benefit of insiders, who are cashing in options at record paces and selling the underlying shares, suspect related party dealings and other governance behaviors have all led us to begin monitoring NVR, Inc. at this time.

Accounting: Company spends most of its cash on repurchases

During arguably the most significant building boom in generations, NVR has chosen to reinvest its excess cash flow in stock repurchases rather than for more strategic purposes. The stock repurchase programs are large relative to the size of NVR's core businesses of home building and financing. In 2002, a period where NVR generated $331 million in net income and $338 million in Cash from Operations, the Company spent $400 million to repurchase shares. And this in a year that saw the shares trading at prices between $300 and $400 each, far up from the $100 to $200 range they traded at in 2001 and the $40 to $60 they averaged in prior years. Through Q3 of 2003, share repurchases have not let up, as NVR spent $240 million in repurchase activity (Cash From Operations for the period was $280 million), and this a year with the shares trading between $400 and $540. Clearly, instead of investing in the Company's future, NVR is taking the tack of buying back its own shares, at historical highs. What possible justification is there for spending so much of investor's money on repurchases at this level?

At first glance, NVR's aggressive repurchase plan looked like an attempt by management to steal NVR from its shareholders by taking the Company private, using the excess cash flow generated from the boom years. If that were so, however, we do not feel that we would be seeing such holdings reductions from insiders (see below). Additionally, (Chairman and CEO) Schar just recently, along with two other investors, bought a 20% interest in the Washington Redskins for $200 million. Though Schar characteristically did not reveal the amount of his investment, we have seen published sources estimating it at about $100 million. Spending the proceeds from some of his stock sales in this manner is not the action we would expect if Schar had plans to take NVR private.

It would seem, instead, that the primary motive for the repurchase activity just might be to get NVR share prices up to levels that will allow its insiders to clear out at very high prices. In other words, NVR seems to be using its boom-generated cash in a fashion that indirectly puts it in the hands of its loyal insider group, most of which have been around since the 1993 reorganization. There doesn't seem to be much in the strategy that will prepare the Company for the eventual period when the boom is over.

Insider Trading: Insiders are taking advantage of inflated prices

The correlation between the Company's unprecedented pace of share repurchases and stock option activity and subsequent sales by insiders is tightening. Insider sales at the Company are at the highest level since it's coming out of Chapter 11 in 1993. Given the high price of the shares, a high level of selling should be expected. The intriguing part of this mix, however, is the fact that some of the key insiders involved, most of which have been with the company since the reorganization, are clearing out long-held options positions and dropping major portions of their holdings in the process. Since early May, their selling pace has been on the rise with over 497,000 shares sold by Section 16 insiders alone. Through the first three quarters of 2003, the same section 16 insiders had sold over 563,000 shares. During that same period, the Company had bought 644,000 shares. Though the insider sales, quarter to quarter, do not seem directly correlated with the Company repurchases, it can be said that the Company repurchases have aided in regularly boosting the stock price and have provided insiders the ability to cash out at successively higher prices, and there's little doubt that the insiders are seizing the opportunity.

As always, we quote insider holdings reductions as a percentage of actionable securities held by the individual involved. By actionable, we mean stock held plus exercisable options. Here are some key details of recent insider sales:

- **Dwight Schar (61)** – Chairman and CEO. Schar has sold 400,671 shares, from May through October, at prices between $380 and $490 each. His trades have dropped his holdings by 40%. They are his largest in the past five years and have netted him well over $175 million.

- **Paul Saville (47)** – CFO. Saville's sales stretch between May and early November and total 90,000 shares. He dropped 27% of his holdings in the process, getting between $403 and $500 per share.

- **William J. Inman (55) -** President of NVR Mortgage Finance. Inman dropped 50% of his holdings by selling 91,100 shares, between May and July, at prices in the $405 range. In doing so, he cleared out of his entire position of $10.63 options, which were not to expire until May of 2006. These were his largest sales in the past five years.

- **William Moran (56)** – Director. Moran dropped his holdings by 30% with his August sale of 8,000 shares. Moran, a director since 1993, had not been a seller through the major portion of the share price rise in NVR. So far this year, he has cleared out of the majority of his position, selling 30,750 shares. We mention Moran below as a director who has profited from selling properties to NVR.

- **Dennis Seremet (47)** – Controller. Between May and August, Seremet dropped his position by 17% with his sales totaling 9,013 shares.

<u>Accounting: Option exercises generating huge tax benefits</u>

The majority of the options being exercised by NVR insiders are deeply discounted from anywhere near current market prices. Most of recent exercises have been for $10.63 each. Since the difference between the exercise prices and the market price of the shares is the primary determinate of the related tax benefit, it should be no surprise that, in 2002, NVR recorded a tax benefit of $101 million as a credit to paid-in capital, eclipsing the $17 million recorded in 2001. Through three quarters of 2003, this tax benefit has totaled another $98 million recorded to paid-in capital.

It would not surprise us if the IRS were to raise questions about the validity of the tax benefit by asserting that frequent, significant purchases of a thinly traded stock by the Company have tended to inflate the market price and therefore a haircut to the stock's value is in order before arriving at the tax benefit.

Accounting: Company pulls out all the stops to increase repurchases

NVR employs a policy of minimal disclosure on virtually all fronts. In cases such as these, the disclosures that ***are*** being made must be scrutinized closely as they provide, begrudgingly, the only available clues as to what may be happening below the surface.

In this regard, disclosure on debt covenants is somewhat revealing, given the Company's proclivity for minimal disclosure. Take, for example, this passage describing restrictive covenants relating to NVR's Working Capital Revolving Credit facility, which expires in May of 2004:

> "The Facility contains numerous operating and financial covenants, including required levels of net worth, fixed charge coverage ratios, and several other covenants related to the construction operations of NVR. In addition, the Facility contains restrictions on the ability of NVR to, among other things, incur debt and make investments. The Facility also prohibits NVR from paying cash dividends to shareholders."

Clearly, lenders have a tight reign on NVR.

But there's more related to debt covenants. Disclosures related to the Company's efforts to increase the size of its authorized repurchases imply that certain covenants contain restrictions prohibiting such action. In late 2000, NVR launched an interesting solicitation of consents from holders of its 8% Senior Notes due in 2005. In it, the Company offered 1% (cash payment) for each note holder who consented to "permit the Company to amend the Indenture in order to provide the Company with greater flexibility to continue to repurchase shares of its outstanding common stock as part of its strategy of maximizing shareholder value." When this didn't work, NVR raised the ante to 4%, then 4.5% before successfully completing, in February of 2001, the solicitation in order to allow for an additional $85 million in repurchases.

A similar situation occurred in March of 2002. This time, NVR succeeded, with a 2% cash payment to each consenting note holder, in increasing its authorized repurchase program by $100 million "in addition to that otherwise provided under NVR's indenture."

The accounting for these one-time cash payments was interesting. Instead of recording the expense in the year of the payouts, the Company amortized them as adjustments to interest expense. Clearly, one-time payments related to original debt issuance are amortized routinely. The amortization of these payments related to the solicitations, however, having no bearing on actual interest expense but instead being related to the need to repurchase additional shares, is aggressive in our view.

<u>Governance: Behavior in several areas is suspect</u>

Our strategic partner, Governance Metrics International, gives NVR some of the lowest governance rankings of any company we've yet to review. Based on our findings, we were not surprised to see GMI rate NVR very low for Shareholder Rights, Ownership Base and Potential Dilution, Corporate Behavior, Financial Disclosure and Internal Controls. As GMI's work is independent from ours, we consider their ranking as confirmation of our current suspicions that NVR's management decisions inure more to the benefit of the close-knit group of Company insiders than those of shareholders with long-term views.

With regards to related part disclosure, we bring your attention to NVR's core operational model by which the Company does not develop land for building purposes, purchasing instead improved lots from developers. The Company discloses that it buys "on a limited basis" land from Elm Street Development Corp., a company controlled by NVR director William Moran. The prices paid to Elm Street totaled $13 million in 2002, $19 million 2001 and $25 million in 2000.

We have become very intrigued at whether or not the Company is buying land from other entities either controlled, or invested in, by related interests. Though NVR offers little disclosure on this subject, we are currently in the process of collecting names of entities from which the Company has been purchasing land. We then intend to search further into these entities to determine whether or they are in any way related to board members or management.

Another bizarre related party situation involves General Counsel James Sack. Sack has acted as General Counsel and Secretary since 1992, yet he has been consistently referred to as a "non-employee executive officer" at the Company. Instead, Sack has operated as a partner in his own law firm, Sack & Harris P.C. through most of the period. This is the kind of relationship we normally expect to see in very small companies in early stages of their existence, not those generating $3 billion in revenues. Up until F/Y 2001 Sack's firm, each year, had billed NVR for legal services. Such services totaled $720,000 in 2001, $560,000 in 2000 and $471,000 in 1999. It is not clear whether Sack remains as a partner in his firm or whether his firm continues to bill NVR for legal fees. What is clear is that Sack is still listed as NVR's General Counsel.