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

FIN 46 and Other New Disclosures Keep Our Attention NVR, Inc. (AMEX:NVR) Update

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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:** Creative FIN 46 disclosure process very revealing
- **Accounting:** Evidence of deteriorating loan quality
- **Insider Trading:** Insider selling and share repurchases accelerate together
- **Accounting:** Allowances related to deposits on land commitments not disclosed
- **Governance:** Funding of Rabbi Trust unusual and beneficial to insiders

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Discussion of 3DAdvisors Findings

NVR's begrudging disclosure policies continue to pique our interest and curiosity. The Company does not hold earnings conference calls, conduct interviews with members of the press and has limited following on Wall Street. Not only are the concerns outlined in our original report (11/11/2003) still on the radar screen, but new ones have surfaced as new disclosures, probably forced on the Company by its outside auditors, reveal more evidence of potential self-serving behavior by Company executives, not to mention areas of business risk heretofore not disclosed.

Accounting: Creative FIN 46 disclosure process very revealing

A central element of NVR's business model is that it does not buy raw land for development but rather purchases "improved" lots from developers, which it then builds on. NVR's pre-FIN 46 disclosures alluded to the deposits and purchase commitments made for this purpose, but fell far short of revealing the exact size of these items. Instead, the Company would reveal only that it routinely made deposits on such properties and that these deposits could be forfeited if NVR failed to perform under any related contract.

Not only is it important to be able to quantify the amount of the outstanding deposits and purchase commitments, but it also turns out that the issue of ***who*** these purchase commitments are with is equally important. It had become quite evident that, in at least one case, NVR has been contracting to buy land from related parties. The Company has disclosed it buys properties from "Elm Street Development Corp.", a company controlled by NVR director William Moran. NVR purchases from Elm Street totaled $15 million in F/Y 2003, up from $13.2 million in F/Y 2002 but down from $19 million in 2001.

These Moran related-party dealings brought up the question as to just whom else NVR may be buying properties from and if any of those entities were, like Moran, also related. This made the approach of FIN 46 a potentially interesting issue, as the new reporting requirements mandated by FIN 46 would require better disclosure of such transactions with outside interests. As deposits were being made, by NVR, in properties where it had made purchase commitments, it stood to reason that NVR could, in many cases, be deemed to have variable interests in the entities involved, requiring them in certain cases to be consolidated on NVR's statements. At the very least, we expected to see the required increased disclosure of such transactions when F/Y 2003 ended.

Going into year-end, however, all that NVR would disclose, related to FIN 46, was that it "had not yet completed its evaluation (re: FIN 46)" and that it "cannot make any definitive conclusion until it completes its evaluation." Upon the release of NVR's 2003 SEC Form 10-K, in the FIN 46 disclosure, the Company chose to consolidate just $12.8 million in FIN 46-related entities on the balance sheet. Explaining the small number, the Company said, "NVR does not have access to the financial records of the development entities with which it enters into fixed price purchase agreements, and as a result was unable to consolidate the variable interest entities' results of operations or cash flows". The Company also "deferred full implementation of FIN 46 on all other fixed price lot purchase agreements until the first quarter of 2004, as permitted under revised FIN 46." In doing so, NVR postponed, until the last possible moment, its disclosures required by the new rule.

All of this did not get the Company out of disclosing a new, and very revealing, related-party transaction at F/Y end 2003, however, where the 2003 10-K announced that NVR had entered into forward lot purchase agreements with Comstock Blooms Mill II, LLC, "an entity 100% controlled by an entity in which (NVR CEO) Dwight Schar's son-in-law is a principal." The disclosure goes on to reveal that NVR had purchased, during 2003, lots totaling $2 million from the entity and had entered agreements to buy an additional $4 million. Any doubts about the extent of related party nature of these dealings were put to rest upon further inspection: Comstock Blooms Mill II, it turns out, is controlled by The Comstock Companies, which builds homes under the Comstock Homes banner in the same Virginia and Maryland area that NVR does. The entity also builds commercial properties under the name of Comstock Partners (they do this in Virginia and North Carolina). A third related entity is the Comstock Group, which deals with "financial services and investments". Two of Schar's daughters are involved with Comstock. One is Tracy Schar, who is the contact person for The Comstock Foundation (a Comstock Companies entity) and Sarah Schar, who is the contact person for leasing at some of the Comstock Partners' commercial projects. We'd be surprised if NVR has no access to Comstock's records!

It would seem that one reason for NVR's reluctance to comply with FIN 46 is the Company's unwillingness to run the risk of having to disclose who some of the participants in it's Variable Business Entities really are. NVR's behavior in this regard has been generally evasive. Even without disclosing the names of the entities involved, the Company could have just as easily disclosed the entire amount of consolidations at 12/31/2003 and, no doubt, had sufficient information to do so. Instead, NVR chose to take advantage of the FASB revision that allowed them to delay further disclosure until Q1. When the final deadline came, true to form, NVR's Q1 release contained evidence that it had indeed been holding back until the end before further disclosing its FIN 46 consolidations: Without any footnote disclosure, the balance sheet, as of 3/31/2004, reveals FIN 46 consolidations totaling $60.6 million, up from the $12.8 million recorded at 12/31/03. In addition, Liabilities related to FIN 46 moved up to $39 million vs. just $12 million at 12/31/03. It will be interesting to see what, if anything, is said about these upon the release of the Q1 10-Q.

NVR's continued evasiveness, with regards to ***who*** it contracts to buy properties from only serves to pique our curiosity further. One potentially revealing case is that of Norair Road LLC, which had sold eight parcels of land to NVR between April 1999 and May 2000 for prices totaling $418,000. Richard Norair had been a director of NVR during that period, prior to his death in 2002, and also had engaged in real estate operations during that period. Though we have yet been able to positively identify Norair's potential ties to Norair Road LLC, the secretive nature of NVR's dealings makes us drill that much deeper in order to find answers. We continue our search to determine just what connections there may be between NVR and the many entities that it buys properties from.

Accounting: Evidence of deteriorating loan quality

We have been watching the progression of disclosure from the Company's mortgage banking subsidiary, NVRM, where $2.4 billion in loans were closed in 2003, as it appears that NVRM has been extending credit to a higher number of sub-prime borrowers each year. Take a look: At 12/31/2001, NVRM disclosed that it had mortgage loans in process, which had not yet closed (Loan Pipeline), totaling $1.1 billion. At the time, the Company's related disclosure indicated that it had expected 100% of these loans to close in F/Y 2002. At 12/31/2002, NVRM's Loan Pipeline stood at $1.3 billion but this time, the Company had estimated that 20% of the number would fail to close. By 12/31/2003, NVRM's Loan Pipeline had moved up to $1.5 billion, but the Company's estimate of what would fail to close had moved up to 25%.

Clearly, there has been a shift in the quality of buyers applying for NVRM loans. This is further supported by new disclosures appearing in the text of NVR's Q1 earnings release (issued April 19) where it was revealed that although closed loan production increased 2% during the March 2004 quarter (over Q1 of 2003), mortgage banking operating income, for the same period, actually dropped by 19%, from $13.4 million (Q1, 2003) to $10.8 million (Q1, 2004). The Company's explanation for this was that "the reduction is primarily due to a shift in product mix from fixed rate mortgages to adjustable rate mortgages…" a pretty clear indication that there has been a reduction in the quality of the loans.

It is generally known that NVR's unit growth was flat in 2003 (over 2002) with the majority of Net Income growth coming from price increases. NVR's flat unit volumes for 2003 had led some analysts to conclude that the Company's model may be out of steam, especially in its main Virginia and Maryland markets where prices of available land have skyrocketed and availability of finished lots has become tight. Some may feel that these concerns have abated somewhat in Q1 of 2004 as unit growth picked up 14% from Q1 of 2003. We don't think so, offering instead that the apparent reduction in loan quality may indicate that recent unit growth experience is more a result of easier credit terms than an improvement in the Company's business model.

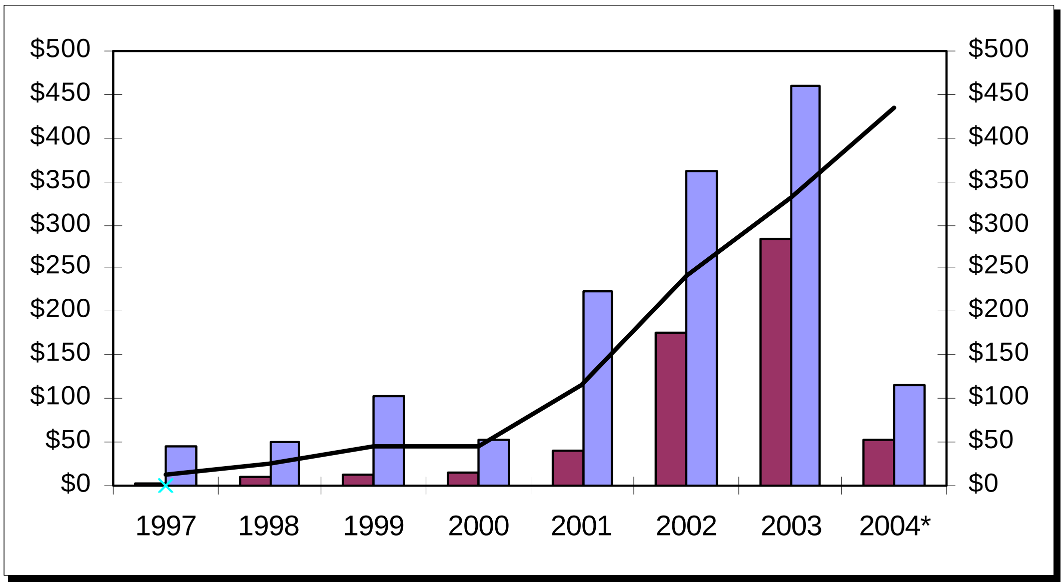
Insider Trading: Insider selling and share repurchases accelerate together

As we have maintained since our last report, there's nothing subtle about the high levels of insider selling that have been coming out of NVR for the past few years. We find it very significant that the selling seems to correlate with the ever-increasing level of share repurchases that NVR engages in each year. Putting this all into even tighter perspective is the fact that, outside of company directors (who are all required to file insider reports under Section 16) there are only four operating executives filing as insiders at the Company, far below average for a company of this size. There are clearly more insiders holding stock than those required to file under the rules. Any selling by them would not be on the radar screens yet possibly be reflected in the high number of repurchases. Although the Company does not admit to purchasing stock from insiders, it very well may be doing so, indirectly at least: Suffice it to say that without a source of supply, such as what the insiders have to offer, NVR would find it difficult to buy the amount of shares (257,000 in Q1 of 2004 alone) in the open market without affecting the share prices in a big way.

There is no doubt that insider selling has been running at high levels, and has increased in correlation with the acceleration of stock repurchases at the Company. Possibly the most revealing fact about the repurchases is that they have accelerated dramatically as the stock price has risen, contrary to the many situations where companies repurchase shares when they are depressed. Buying in stock at such high prices does not seem to be the best use of Company cash, unless that is, you are an NVR insider with lots of stock to sell.

The most aggressive seller in the insider group is Chairman and CEO, **Dwight Schar**. Since our last report, he has let go of another 102,356 shares and has now reduced his holdings by 42% since March 1, 2003, which is truly a significant reduction for a Chairman/CEO who is also the Company's largest shareholder. But there's more to the insider reductions here: Since March 1, of 2003, **William Inman**, President of NVR Mortgage Finance, has trimmed his holdings by 36% and CFO **Paul Saville's** holdings have declined by 14%.

Figure 1. NVR, Inc. Insider Sales (Red Bars), Stock Repurchases (Blue Bars) and Stock Price (Black Line). Insider Sales and Repurchases are in Millions $ (left scale), Stock Price is the Closing Price on the last trading day of January for the year indicated in dollars per share (right scale). Source: NVR, Inc. SEC Filings and Reuters.



* Insider sales and stock repurchase data through Q1.

For the past two years, NVR's stock repurchases have exceeded net income. So NVR, during arguably the biggest building boom in a generation, chooses to invest its cash by buying its own shares back at inflated prices in actions that seem, indirectly at least, to inure directly to the benefit of Company insiders. Our question quickly becomes, "What are you leaving for a downturn?" After all, this is the same management team that was intact when the Company declared Chapter 11 in the early '90's.

NVR's insider stock options are deeply discounted from current market prices as most of the recent option exercises have occurred in the $10.25 range. The sale of these optioned-for shares generates huge benefits for NVR as the difference between the exercise prices and the market price for the shares (at the time of the sale) is the primary determinate of the related tax benefit. In 2003, NVR's option related tax benefit topped $110 million, up from $101 million in 2002, which is a huge jump from just $17 million recorded in F/Y 2001.

These benefits may very well begin a decline as the majority of the Company's deeply discounted $10.25 options have been exercised. NVR has not granted new options since 2001 so, with all the recent exercising, the pool has become depleted. Dwight Schar, for instance, is by far the largest recipient of the Company's option plan and he is out of his old $10.25 and $10.625 options. In February, he exercised all he could of his $47.63 options (83,333 shares worth). These are the highest-priced exercisable options outstanding for the Company. The 2001 grant, exercisable at $189 per share, will not be exercisable until December 2006.

Accounting: Allowances related to deposits on land commitments not disclosed

As we have noted above, NVR's disclosure policy regarding finished lot purchases has fallen short, in the past, of quantifying the amount of purchase commitments made and the total number of related deposit commitments. These deposit commitments are significant as they are non-refundable in the event of NVR's failure to perform under the contracts. Yes, the amount of deposits remaining show up on the Balance Sheet. In 2002, for instance, NVR recorded $231 million in Contract land deposits but offered no guidance as to how large its related overall purchase agreement commitments had been. Now, possibly as a result of the new FIN 46 requirements, NVR has added disclosure as to the size of its purchase agreements. The 2003 10-K revealed off-balance sheet purchase agreements totaling $5 billion where the Company had either made deposits on these commitments totaling $370 million in the form of cash or letters of credit.

Since the deposits are generally not refundable NVR maintains a related allowance but fails to disclose its amount. NVR indicates that it considers its allowance adequate but acknowledges that adverse changes in the economy (read: higher interest rates) could find this allowance insufficient. NVR simply does not disclose details on any of its reserve practices. Nowhere in NVR's disclosures are there schedules containing allowance detail of any kind, for any contingencies. We are left to trust management's discretion in these matters.

Governance: Funding of Rabbi Trust unusual and beneficial to insiders

NVR has a Rabbi Trust, created for the Deferred Compensation Plans of some of the company's top management individuals. Unlike most Rabbi Trusts, which remain unfunded, this one has been funded with $64 million in shares repurchased by the Company (separately from the repurchases mentioned above) for purposes of deferred compensation. Most of this deferred compensation is related to deferred payouts from the Company's High Performance Compensation Plan (terminated in 2002), which used EPS as a primary target for determining management performance payout. Quite ironic, given the aggressive repurchase programs in effect.

It is rare to see Rabbi Trusts funded until the obligation for which they were created comes due. To us, the funded nature of NVR's trust is a case of management making sure they are well taken care of.