This 3DAdvisors Report Covers:

- ✓ **Insider Trading**: Insider Trading Behavior
- ✓ **Accounting**: Quality of Earnings Issues
- ✓ **Governance:** Corporate Governance Issues

Chairman Makes His Move Before Bubble Bursts?
WCI Communities Inc. (NYSE:WCI)

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WCI Communities, Inc. is a fully integrated homebuilding and real estate services company with experience in the design, construction and operation of leisure-oriented, amenity-rich, master-planned communities. WCI designs, sells and builds single- and multi-family homes serving move-up, pre-retirement and retirement home buyers. The Company also designs, sells and builds luxury residential towers targeting affluent, leisure-oriented home purchasers. The Company acquires and develops the land in its communities, constructs the residences, designs, builds and operates the amenities in many of its communities and otherwise controls most aspects of the planning, design, development, construction and operation of its communities. In certain situations, it elects to sell parcels and lots to others, including other builders and developers or end users.

Summary of 3DAdvisors Findings for WCI

- **Insider Trading:** Unusual and significant forward sale disclosures by Chairman
- **Insider Trading:** Chairman's behavior makes conventional sales stand out
- **Accounting:** Revenue accounting in speculative condo market has big risks
- **Governance:** Board connections with Florida governor and other conflicts
- **Governance:** Interesting shuffle with director position is revealing
- **Governance:** Related party disclosures underscore questionable board structure

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Discussion of 3DAdvisors Findings

The spate of recent open market sales at WCI that have been covered elsewhere didn't do much for us, but the cluster of three stealthy forward sales (F/S) entered into by key insiders in early March are another thing altogether. The F/S transactions were executed as the shares were weakening on concerns over the overheated Florida condominium market (WCI is one of the only publicly traded condominium builders in South Florida), concerns that were exacerbated by a recent analyst downgrade that assessed the future prospects for the shares to be "neutral at best". Making matters more interesting is the fact that the forward sales were filed in a manner that materially understated the true amount of shares actually pledged by former CEO and current

Board Chairman **Alfred Hoffman Jr.** (more on this below). The aforementioned open market sales by additional insiders in February now loom considerably larger to us. All of this of course has led us to drill into accounting and governance behavior at the Company, an effort which has proven to be quite fruitful.

WCI's continuing concentration in the white hot condominium market is exposing the Company to increasing financial risk, due in part to the utilization of percentage of completion revenue accounting. In addition, there are a series of related-party dealings that seem oddly out of place in the post Sarbanes-Oxley era, especially given the fact that three board members have ties to the administration of Florida governor Jeb Bush. The combination of these management behaviors frames an interesting risk picture, particularly given the current upward bias developing in interest rates and the potential for a bubble-burst in the Florida condominium market.

<u>Insider Trading: Unusual and significant forward sale disclosures by Chairman</u>

The disclosure of Hoffman's forward sales is truly unique when compared to virtually all other forward sale filings that we have seen. When insiders file such transactions, their brokers usually require that a Form 144[1] filing be submitted to the SEC simultaneously with the related Form 4[2]. In virtually every forward sale we've ever seen, the attendant 144 shows the same number of shares intended to be sold that is disclosed on the Form 4. In other words, when an insider files a Form 4 indicating a F/S for, say, 100,000 shares, that insider (or his/her broker) then files a 144 indicating the intent to sell the same number of shares. Not so for Hoffman whose Form 144 filings, issued in conjunction with his Form 4 F/S disclosures, consistently indicate that he intends to sell double the amount of shares indicated on the Form 4.

How could this be? To understand what is happening here one needs to understand that, in most cases, the number of shares actually sold (at expiration) under a Forward Sale contract frequently does not match exactly the amount initially indicated on the Form 4 disclosing the transaction. Typically, the actual amount to be delivered is contingent upon the price of the underlying shares at the contract's expiration. It has been our experience that most (if not all) of the contracts we have seen over the years ultimately result in the delivery of either slightly less or the same amount shown in the initial Form 4 disclosure. In other words, typical F/S disclosures reveal the maximum amount (or thereabouts) of shares that could be delivered under the agreement. Consequently, the amount of shares indicated as pledged to be sold usually mirrors the amount revealed as intended to be sold on the simultaneously filed Form 144.

Hoffman's obfuscation is truly unique. The Form 4's disclosing his forward sales consistently show half the number of shares pledged in the deal as he intends to sell according to the simultaneously filed Form 144. In doing this, it is quite evident that his Form 4's indicate only the minimum amount of shares that may ultimately be delivered under the F/S contract. We have reviewed our extensive list of forward sale filings by insiders at all companies and can tell you that we've never seen this sort of distortion. And now for the impact of Hoffman's Forward Sale transactions: Going by his Form 4

[1] SEC Form 144 – Notice of Proposed Sale of Securities Pursuant to Rule 144 Under the Securities Act of 1933.
[2] SEC Form 4 – Statement of Changes in Beneficial Ownership

disclosures, one could infer that he has pledged, in total, just under one million shares, or 20% of his actionable holdings under these contracts, 556,300 of which were pledged in early March. However, given the fact that his 144's reveal double the amounts indicated on the Form 4's, the correct assumption is that his total obligation under **the F/S contracts he has entered into has tied up as much as 40% of his holdings.**

Hoffman's filings are filed by a trustee (Mary Ann Wilson) of a trust, the Alfred Hoffman Jr. 2003 Long Term Trust, of which, we must assume, he is a beneficiary. Nowhere, in any of his current, or past, F/S filings, is the cash amount he received revealed under any of these agreements. If his cash received is anything like what his associate, CEO **Jerry Starkey**, received in his March 11th forward sale (where he pledged 92,069 shares), he may have accepted a similar 16% discount from market price as Starkey did. Starkey's F/S disclosure, unlike Hoffman's, revealed the discount he accepted. A typical Forward Sale contract involves a discount of about 10% from the market price of the shares involved in the transaction. The fact that Starkey accepted a higher-than-normal discount is also interesting to us, and the fact that Hoffman did not disclose the cash he received for pledging his shares is probably not an accident.

In addition to the above obfuscations, we also find it interesting that, in early March, as WCI shares began to show some cracks, these three Forward Sales surfaced, two by Hoffman and one by Starkey. Although Hoffman has engaged in F/S transactions in the past, none of them have been close to the size, nor as closely-spaced, as the two that have just recently occurred.

Insider Trading: Chairman's behavior makes conventional sales stand out

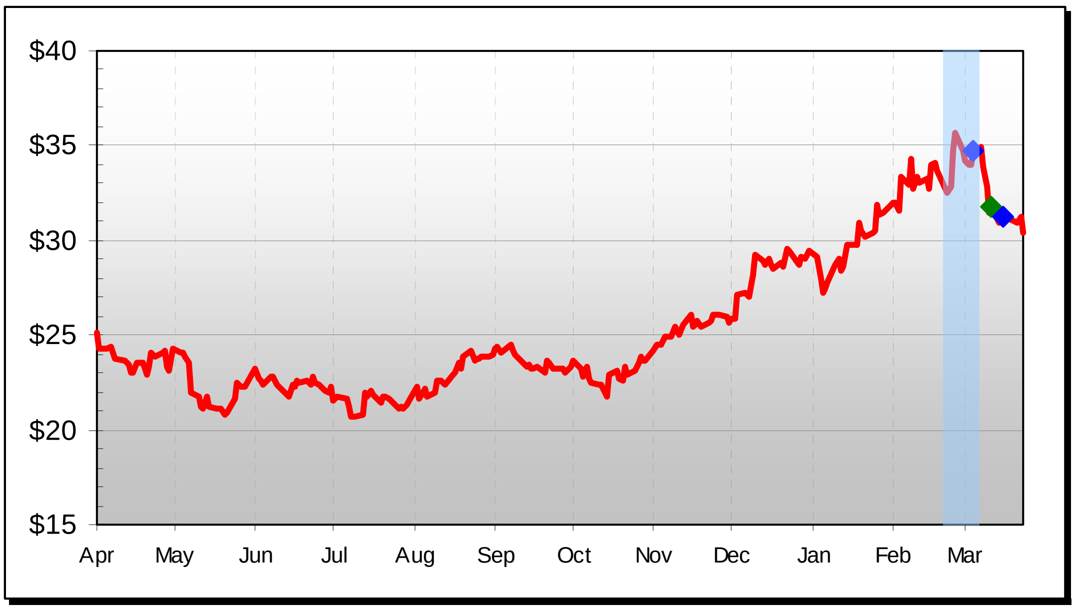
Since shares of WCI Communities have only been trading since early 2002, and insiders were locked out for the first six months, we have a limited depth of trading history to analyze. Normally, this would impede our ability to properly assess any behavioral patterns. The middle-management activities we have observed, however, being the first of such volume since the IPO, in conjunction with the accelerated forward sale transactions of top management, represents an anomalous occurrence. From February 22nd through March 7th, ten insiders sold a total of 339,843 shares on the open market at an average price of $33. This is in addition to the 748,369 shares (at minimum) pledged by both Hoffman and Starkey. Here are some of the more interesting sellers:

- **Jim Dietz (39) -** Senior V.P., CFO. Leading the broad-based round of selling was first-time seller Dietz, who exercised three options series granted between 1998 and 2000 which weren't set to expire until December 2008. Dietz sold the newly-acquired 57,403 shares, **equal to 22% of his holdings**, at an average price of $32.70. These were his first sales since the Company's IPO.

- **David Fry (44)** – GM, Amenities Division. Fry monetized a total of 49,380 shares, **or 21% of his actionable position** (exercisable options plus common stock) after acquiring the shares from the exercise of two options set to expire in 12/08 and 1/13. Prior to this sale, Fry had sold a total of 33,012 shares in March 2004 and August 2004 at roughly $23 a share.

Executives in the upper echelon of WCI's management aren't the only ones to have sold. Senior V.P., Business Development **Vivien Hastings**, V.P. **John Ferry**, and Senior V.P., Homebuilding Division **Michael Greenberg** are three "unnamed" executives who surfaced in the recent round with their first sales to date. Ferry's sale trimmed his holdings by 31%, but due to a lack options disclosure for Hastings and Greenberg, it is impossible for us to accurately compute their percentage reductions in holdings.

Figure 1. WCI Daily Closing Price, April 1, 2004 through March 23, 2005. Shaded blue area is where 10 insiders sold 339,843 shares. Blue diamonds are the dates of Hoffman's forward sales; Green diamond is the date of Starkey's forward sale.



<u>Accounting: Revenue accounting in speculative condo market has big risks</u>

For the past few years, WCI has experienced margin contraction in its single family unit sales. The Company has offset this with an aggressive strategy of accelerating its commitment towards tower condominium construction. Condo towers are among the most popular vehicles for speculators in the Florida real estate market as they offer the small to intermediate speculator the opportunity to participate in the fast real estate game, buying in at pre-construction prices, with hopes of flipping the units as soon as possible.

WCI accounts for its Tower Homebuilding revenues using percentage of completion methods, taking in deposits at the pre-construction phase, and then procuring financing for construction in order to build out the project. As construction progresses, revenue recognized is "calculated based upon the percentage of total costs incurred in relation to estimated total costs". Plenty of latitude here and possibly good part of the explanation as to how margins in the Tower Homebuilding area have been coming in at far better levels than what the Company has been experiencing with single-family homes (30% vs. 18% in 2004).

WCI is quick to state how defaults under these Tower contracts have ranged between just 1% and 2% historically. When considering this statistic, however, one must remember that these figures represent the best-case scenario of a hot market where speculators (going long condos) have been on the right side of the trade because of the booming market, in part driven by historically low interest rates in Florida and elsewhere.

The prominence of these contracts on WCI's balance sheet is clearly significant. The Company segregates receivables associated with Tower Contracts separately from its regular receivables, calling them Contracts Receivable (C/R's). These C/R's were at $760 million (26% of total assets) as of 12/31/04, up 39% from $547 million at 12/31/03. WCI expects to collect just $453 million of these C/R's in 2005, with the remainder in 2006. The volatility of this asset value is quite interesting when you consider the potential bubble state of the Florida condo market. What's more is the fact that, although WCI does not break out current vs. long term assets on its balance sheet, it does list the entire $760 million of Contracts Receivable just below Cash, Restricted Cash and Cash Equivalents and above its regular Accounts Receivable, implying that these C/R's are current assets. With 41% of the C/R's estimated by the Company not to be collected until 2006, it is easy to question the validity of implying the whole amount to be a current asset.

Of course the real question concerning the quality of this asset has to do with the impact that the continued upward bias in interest rates might play. It is quite clear that the majority of buyers in the South Florida condominium market are speculators; *The Miami Herald* recently estimated (3/11/05) that as much as 85% of the condominium sales in downtown Miami are speculators or investors, not home buyers. While no one knows exactly where interest rates will be a year from now, it's a pretty safe bet that they will continue to rise from their current levels. The question is whether or not they will be high enough to burst what many feel is a speculative bubble in this market, and the impact on WCI's balance sheet and earnings could be significant.

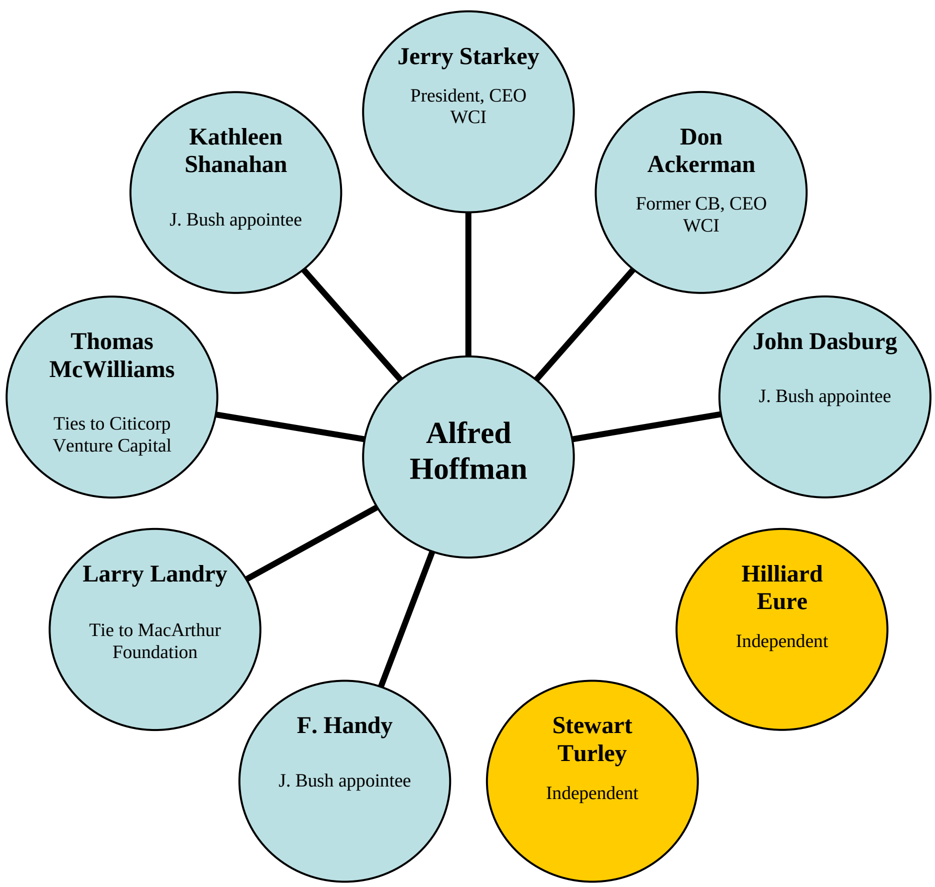
<u>Governance: Board connections with Florida governor and other conflicts</u>

Every once in a while, we come across companies that have boards packed with friends, business associates and political contacts that have interests and motivations that might not necessarily be aligned with those of shareholders, almost as if Sarbanes-Oxley never happened. WCI is one such company, and we didn't have to dig very hard to find behaviors between the directors, their outside interests and the Company that caught our attention. On an individual basis, many of these relationships might have little significance, but our concern is that when you add it all up, there appear to be more than just voting blocks, as a majority of directors have common interests that make it almost impossible to avoid conflicts.

First off, let us point out that most governance watchdogs strongly believe that a board should not have more than two current and/or former company chief executives as directors at one time. WCI has had three current and former CEOs on the board dating back to 2001. But the more interesting thread connecting board members is actually politics. Chairman and former CEO Alfred Hoffman, a self-professed "political junkie," has spent years aligning himself with the Bush family, having been appointed to a number of positions on both George W. and Jeb's campaign committees.

But we're not as concerned with his political involvement as we are with his handpicking a number of Jeb Bush "cronies" to sit on WCI's board. **F. Philip Handy**, who received a Bush appointment as chairman of the Florida Board of Education, was the first addition back in 1999. After independent director **Jay Sugarman** resigned from the board in May 2004, it was Handy who took over his position as chairman of the Nominating/Governance Committee. But just before Sugarman left, Handy (along with Hoffman) recommended **Kathleen Shanahan** be added to the board, which Sugarman quickly pushed through before he left. This is significant because Shanahan was Jeb Bush's chief of staff from 2001 through 2003. Then, less than five months later, WCI Communities announced that they would be adding former Burger King head **John Dasburg** to the board to fill a vacancy. But while this addition might seem to be a break in pattern, Dasburg was actually appointed to the Board of Governors of the Florida university system by none other than Jeb Bush.

Figure 2. The WCI Board of Directors. Source: WCI SEC Filings.



One reason we are interested in the number of WCI board members with ties to Bush is because of an apparent favoritism shown by the Governor towards large real estate firms. An article in *The Washington Post* dated June 25, 2002 said, "Florida's governors have preserved more than 1 million acres of green space, but their growth-management efforts have failed for decades, and Jeb Bush's administration has been especially close to real estate interests." It also mentions a few pieces of legislation signed by Bush, such as an "Everglades funding bill that included language proposed by home builders limiting the rights of some citizen groups to fight development permits." Indeed, Bush has given preferential treatment to Hoffman for a number of years. Here are a few examples:

- Hoffman purchased a Coral Gables yacht club in 1997 from Armando Codina, for what many said was a steal. Codina was Jeb Bush's partner in a real estate firm.

- Bush also gave Hoffman a deal on the Deering Bay golf community in South Florida, which was owned by the Bush/Codina partnership.

- Hoffman heads an exclusive advisory panel called the Counsel 100, which includes the top 100 CEOs in the state of Florida. They advise Jeb Bush on policy.

- Hoffman was also able to get Governor Bush to create in late 2003 the new state Office of Destination Florida so that state funds could be used to attract even more senior citizens to retire in Florida, providing even more business for developers like Hoffman. Hoffman is also active in getting the state to support transport of water from the panhandle to southern Florida to keep the development boom alive there.

If these connections aren't enough to pique your interest, **Thomas McWilliams** (more on McWilliams below) and **Larry Landry** are involved with two of the original investment groups that funded WCI and at one point, were two of its largest shareholders. Landry, the former chief financial officer of the MacArthur Foundation, which sold a vast amount of undeveloped land to the Company, has had more recent real estate deals financed by the another initial WCI investor, the Kamehameha Schools, which again is closely tied to Hoffman.

Governance: Interesting shuffle with director position is revealing

The disclosure of WCI's 2003 stock repurchase plan is short, but revealing: "In April of 2003, the Board of Directors approved the repurchase of up to 1,000,000 shares of the Company's common stock. Pursuant to this authorization, the 1,000,000 unregistered common shares were repurchased in a private transaction…" The fact that the company was purchasing unregistered stock in a private transaction is unusual to begin with, but the details, once uncovered, were even more interesting.

It turns out that the shares were purchased from Citicorp Venture Capital (CVC) in May of 2003, one of the original investors in the Company. Not surprisingly, WCI had a director on its board, Thomas McWilliams, who had served as CVC's "designee" director during the period when Citicorp held WCI shares. McWilliams had served as a WCI director between 1999 and 2002 before resigning, and continues to be a member of CVC's investment committee. What's interesting is that it was after McWilliams' resignation from the WCI board that the Company purchased the 1,000,000 shares from CVC. After the purchase, which satisfied the entire 2003 WCI repurchase authorization, McWilliams was again elected to the WCI board where he continues to serve today. This is one of the more interesting examples of "board shuffling" that we've come across.

Governance: Related party disclosures underscore questionable board structure

WCI's section of Related Party Dealings provides good reading. The most interesting revelation is the disclaimer at the head of the section (which appears in the most recent Form 10-K) which states that **"the terms of the respective agreements might not be the same as those which would result from transactions among wholly unrelated parties".** This is truly a rare disclosure as it reveals that, without a doubt, the Company could not make the statement that its dealings with related parties have been conducted as if the parties were independent. Quite frankly, we have yet to run across a mea culpa of this nature at any other company.

It is clear that WCI had no choice but to offer the above disclosure (independent auditors and attorneys probably wouldn't permit its omission). We're confident that the disclosed related party dealings (the more interesting ones described below) contain more "devil in the details" than what has been offered by the Company:

- ➲ An undisclosed shareholder provides "financial and management consulting services to the Company under a management contract. Management fees totaled $660,000 for each of the years ended December 31, 2004, 2003 and 2002, respectively". It is interesting to note that this disclosure only occurs in the respective Form 10-K's and not in the annual Proxies.

- ➲ WCI entered into a lease agreement, with an undisclosed related party, for an office building in 1997 and currently pays $2.3 million annually in the deal, up from $1.6 million in 2002. This deal expires in 2007.

- ➲ WCI has another deal, again with an undisclosed related party, whereby it has entered into five separate lease agreements for office space. This deal totaled $550 thousand in 2004, up from $467 thousand the prior year.

- ➲ WCI leases two airplanes from related parties (again, undisclosed) and paid $1.1 million under the deal in 2004, up from $881 thousand the prior year.

- ➲ WCI acquired 29 acres of undeveloped land in Naples, Florida (in October of 2004) from a joint venture in which the Company holds a 51% ownership interest.