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

Questions About Q2 Results; More Forward Sales
WCI Communities Inc. (NYSE:WCI) Update

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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

- **Accounting:** Curious timing and effect of Florida land sale
- **Accounting:** Did the need for cash drive the Florida land sale?
- **Accounting:** Before auditor switch, condo and homebuilding margins overstated
- **Accounting:** Indications of a tightening loan market for commercial construction
- **Insider Trading:** Insiders continue to use forward sales to drop holdings
- **Accounting:** Trouble with recent Virginia land purchase

Discussion of 3DAdvisors Findings

Stealthy and persistent use of forward sales by key insiders to monetize large portions of their holdings, huge “Contract Receivables” emanating from heavy dependency on Percentage of Completion accounting, a curious auditor switch in the wake of a large land sale, and growing exposure to the frothy South Florida real estate markets are all items in this update that combine to make WCI Communities one of the more interesting companies we’ve studied. Management seems bent on heralding the gains from the current South Florida speculative real estate mania as if it were a sustainable phenomenon. In the midst of this, we continue to hear rumblings that commercial lenders in WCI’s market are becoming increasingly cautious with regards to providing ready funds for large projects (such as Tower Condominiums, WCI's largest growing market) where speculators dominate the scene. Yet, such risks simply are not discussed by the Company.

This behavior of overstating the positives while understating (or ignoring) the risks is something we've seen the likes of before. Avon immediately comes to mind as a recent example. Avon's management, with a flair for hyperbole in earnings announcements and analyst presentations, until recently spoke glowingly of its growth prospects overseas (despite an ailing domestic market), with little or no mention of the risks. But the "everything is great" message was in stark contrast to the accounting and trading behavior we had observed, especially a penchant for shipping unordered goods to independent reps for which revenue was recognized, and of course, significant and timely reductions in the actionable holdings of insiders. With Avon's recent Q2 earnings, investors got a lesson on why it's important to pay attention to actions, rather than just words.

Some of this type of management behavior is evident at WCI, making us feel like we've seen this movie before. "WCI Reports 294% Rise in Second Quarter 2005 Earnings", the headline of the recent Q2 earnings press release gushed. Never mind that a huge part of the growth came from a one-time gain on the sale of property in Florida, or that a big chunk came as a result of the Company going dramatically further out on a limb in the speculative Tower Condominium market (recognized revenue up 57.6%) where it uses the Percentage of Completion method of accounting (more on this below). But forget that, there's more good news! Management quickly followed up the spectacular Q2 results with the announcement of a 1 million share stock buy back, implying that WCI shares will not be getting cheaper anytime soon.

If everything is so sunny and devoid of risks, however, we wonder why the very actors in this movie, the ones reading the lines, have been quietly contracting to monetize so many of their shares in forward sales contracts in recent months, a behavior that seems designed to evade detection by investors and the media.

Accounting: Curious timing and effect of Florida land sale

WCI closed a long-awaited sale of property in the Jupiter, Florida area on May 20th. Just four days later, the Company announced that it was dismissing its auditors PriceWaterhouseCoopers (PWC). The switch caught our attention because two weeks then passed before WCI announced the hiring of E&Y, suggesting that the switch was abrupt and unplanned.

The unexpected dumping of PWC, without having a replacement auditor lined up, grabbed our attention, especially since on the heels of the new auditor switch came the closing of the Jupiter property, a sale that contained some interesting twists. The $100 million sale (to Toll Brothers) contributed heavier to WCI's bottom line than was expected with a 40% contribution to the Company's gross margin for the period. Gross margin on the sale was $76 million (WCI declined to indicate the margin in percentage terms), way above the $15 to $20 million they had originally projected. When asked about the margins, (was the higher profit a result of better than expected margins or a larger than expected property sale?) management's comments were somewhat vague: "Originally we were planning that this parcel would be sold over a multiple-year period;

and we ended up selling about a third more of the property than we had expected. We also got a higher price. So we saw some margin expansion, but we sold a larger portion than we had planned." OK, so what was the margin?

The remaining 38% of that Jupiter area property, about 300 acres, will be sold by WCI, probably next year. When asked about the margin expectations for that piece, the Company indicated that, when sold, it would probably have margins more in line with their historical averages which, according to the Company, range between 30% and 50%. When pressed again on the cost basis allocation for the sold parcel, WCI indicated that costs for the $100 million sale were allocated on a relative sales value basis. It's interesting that they chose not to use a per acre carrying cost, and allocate according to just how much was sold. This becomes very interesting when one considers that one of the components of the remaining parcel were a golf course and luxury home sites, while the other was "principally a resort community with a golf course, some condos, timeshares, and a hotel." CEO Starkey went on to explain, "So we would be conservative on projecting values for the resort portion of the parcel". Inside talk in South Florida is that golf community projects, such as those involved in the unsold parcel, are difficult to move in the current environment. Indeed, one million dollar home sales "continue to be slow" according to WCI.

So it could very well be that WCI, in allocating its cost basis on a relative sales value across the entire parcel (both sold and what they have retained), chose a method designed to produce a higher margin for the land sale in the current quarter and to delay dealing with any coming lower margins (from the sale of the remaining property) for another time.

<u>Accounting: Did the need for cash drive the Florida land sale?</u>

With $1.1 billion in outstanding Contract Receivables from Percentage of Completion Tower revenues, and a 24 to 36 month build cycle per tower, it's not a complex exercise to understand that WCI's cash needs expand dramatically with its increased commitment to Tower construction. With no completed Towers in Q2, WCI's total liabilities for the period climbed $335 million, to $1.48 billion. Granted, this should ease somewhat by year-end as the Company plans to complete 2 to 4 towers in the next two quarters.

The long Tower cycle, however, puts WCI's Percentage of Completion revenues in an interesting light. With the 24 to 36 month cycle, and the Company's commitment to Tower construction growing, the long-term portion of WCI's large Contract Receivables grows as well. But WCI continues to give the impression, at least on its balance sheet, that its Contract Receivables are largely short-term. Although the Company does not break out short vs. long term assets in its financials, it carries its $1.1 billion Contract Receivables right below cash, creating the impression that their collections will be quite shorter than is the case.

To this we feel compelled to note that WCI continually touts its 1% default rate on its Tower Condominiums. Of course, this is with combined tailwinds of benign interest rates and a speculative South Florida condominium market. One wonders what the default rate will look like when the winds shift. An indicator may be the post 9/11 period when, in Q3 of 2002 (period ending 09/30/02), WCI had to reverse $35.4 million in previously-recognized Percentage of Completion revenues in two Naples, Florida area Towers when buyers walked out on their contracts, either through defaults or when given the opportunity due to contractual loopholes. At that time, the reversed revenues represented 8% of the Company's $421 million in contract receivables.

All this makes the recent large land sales in Palm Beach County curious. We have been advised, from local sources, that the large parcel recently sold by WCI is just about the last available of such development land in the area. With only $67.5 million in unrestricted cash on the balance sheet as of 06/30/05, we wonder if selling it to Toll Brothers was driven by a need for cash to help bridge the growing time gap between revenues recognized and their ultimate collection for Tower Condos.

Accounting: Before auditor switch, condo and homebuilding margins overstated

WCI disclosed that in its current quarter, as a result of "discussions about accounting calculations and so forth" with the new auditors, "those discussions led us to conclude that a calculation should be revised". WCI revised the calculation of capitalized interest pertaining to homebuilding inventories. Prior to the change, the Company had capitalized interest only on the land development cycle, not the homebuilding component. Interest on homebuilding was carried below the operating line in interest expense. By charging related capitalized interest expense against homebuilding, WCI now is required to show its true margins related to homebuilding which, heretofore, had been overstated. The Company downplayed this, however, choosing instead to focus on how the capitalized interest calculations raised net income by $4.8 million (including cumulative effects), or $0.11 per share for the period ending 06/30/05 (Q2).

While WCI focused on the change as a positive to net income, it downplayed the true effect it had on the Company's eroding homebuilding margins. WCI's growing backlog is not pretty. Construction delays, caused by the 2004 hurricane season and subsequent permitting delays have collided with increasing commodity costs, melting margins in the process. From 20.5% at 03/31/04, homebuilding margins dropped to 15.3% by 03/31/05. According to the Company, they rebounded a bit in Q2 (06/30/05) because of the reduction of the effect of some of the delayed 2004 hurricane closings. The rebound, would have been to 18% in Florida but, with the change in the accounting calculation (of interest), the actual margin, for Florida, for the period was just 16.8%. The point here is that, prior to the calculation, homebuilding margins, in all of WCI's areas were simply overstated. For instance, the change moved Q2's 14.5% margin for mid-Atlantic region down to 13%; ditto for the Northeast where WCI's homebuilding margins of 16.5% (for Q2) dropped to 14% after the adoption of the change.

We also note that upon the release of WCI's earnings, it became evident that there were certain changes made in the way capitalized interest is calculated for its Tower Condominium segment. Although the Company went to certain lengths to explain the reasoning for changing its handling of homebuilding interest expense, what was not explained at all was what caused the changes in the interest calculation related to Tower projects. This change caused a 120 bp reduction in Tower margins, exacerbating already-dropping margins and bringing the number, for the period, ending 06/30/05 to 26.3% from 32.1% for the same period in 2004, which did not include the change. So, as in the case of pre-change Homebuilding margins, WCI's Tower margins had also been overstated in prior periods. In the final analysis it was not just a matter of adding interest capitalization for homebuilding, but rather it looks as though the whole method of calculating all interest capitalization was changed. Apparently E&Y did not like what it saw. That could foretell other things E&W may not like when they get into things.

Accounting: Indications of a tightening loan market for commercial construction

Our sources in South Florida continue to tell us that lenders are becoming more cautious with regards to condominium construction loans. At least two large players in the area, BankAtlantic and Colonial Bank, have ceased providing construction loans for large condominium projects, the likes of which WCI builds. Loans for undeveloped land, at least in the Palm Beach County area, have become tougher as well: One year ago, one could finance 80% of a parcel. Now, we're told that banks in the area are not willing to finance over 65%.

All this dovetails with what we had included in our recent *Research Notes* (08/02/05) where we describe how those commercial lenders who are providing financing for large condominium projects are influencing developers. For the past two quarters, these lenders have been increasingly concerned about the practice of downstream condominium purchasers "flipping" units prior to closing on the property. This has been a common practice in the S. Florida market which has greatly exacerbated the speculative froth that continues to exist in the area.

Generally, construction loans are not approved until a substantial number of units are under non-cancelable contracts and the developer has collected deposits from the purchasers which, in WCI's case, range from 10% to 30%. Up until recently, our sources tell us that WCI, through its large circle of "friends and family", has been able raise capital quickly for its projects because it aids purchasers in the flipping game by permitting assignment of pre-construction contracts prior to actual closing.

Our legal contacts involved in the S. Florida commercial market inform us that lenders, concerned about these pre-closing "flippers" selling into the same market as the developer, have increasingly been adding restrictions in their loan agreements with developers that disallow the practice of pre-closing assignments by downstream buyers. These restrictions have quietly become commonplace, at the commercial loan level the size of which is required by WCI in order to commence construction on one of its Tower Buildings. Whether this affects WCI in every loan situation, however, is not certain at this time. Suffice to say, however, if the limitations make the investment less attractive to the initial buyers, this could very well help cool the demand for condos in this market which is largely driven by speculators looking to make a quick buck.

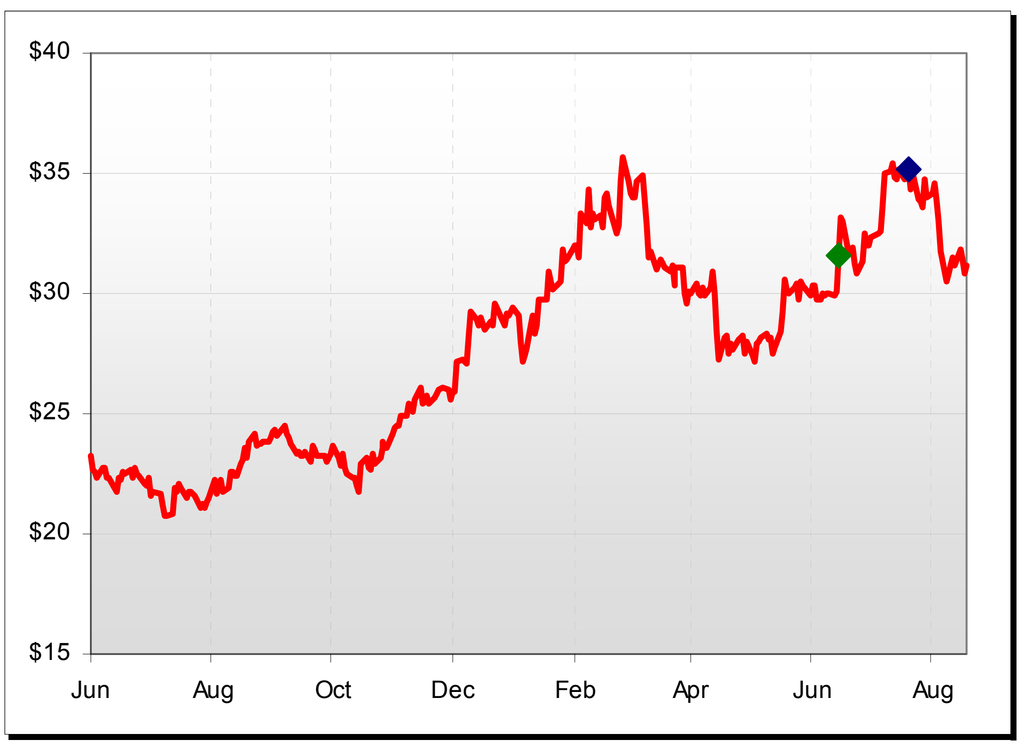
Insider Trading: Insiders continue to use forward sales to drop holdings

Since March, we have issued two 3DA reports on WCI (March 24th and June 22nd), highlighting, along with a number of issues, certain insiders' use of stealthy forward sale contracts to monetize significant percentages of their holdings. The last activity we covered involved Director **Alfred Hoffman**, who entered into a forward sale for 1 million shares on June 15th, by far his largest derivative activity to date. Following the transaction, he now has 60% of his holdings pledged. Since that last report, another director has surfaced with his own derivative activity.

On July 20th **Don Ackerman** (71), a board member since 1995 and former chairman through February 2005, entered into a “Variable Prepaid Forward Agreement” with Credit Suisse First Boston covering 500,000 shares to be delivered by July 2008. No where did the word “sale” show up in the Form 4, and in fact, he presented the transaction as an “acquisition” on Table II of the filing. He did not provide any details as to how much cash he received up-front for the shares.

No attempts have been made by Ackerman or the Company to conceal these transactions. In November 2003 it was disclosed that Ackerman entered into a 10b5-1 plan to monetize up to 500,000 WCI shares. He would later amend the Plan, increasing the share allotment to 850,000 shares. This wasn’t his first derivative activity under the Trading Plan, as he had already opened two contracts in the first quarter of 2004 covering a total of 334,000 shares, not to mention the 1 million shares pledged prior to the Plan’s adoption. In all, Ackerman currently has 1,834,000 shares monetized, **equal to 53% of his holdings**. Although they’ve disclosed the activity, it doesn’t emasculate the fact that WCI’s two largest inside shareholders have monetized over 50% of their holdings.

Figure 1. WCI Daily Closing Price, June 1, 2004 through August 18, 2005. Green diamond is the date of the 1,000,000-share forward sale entered into by Alfred Hoffman; Blue diamond is the date of the 500,000-share forward sale entered into by Don Akerman. Source: Reuters and WCI SEC Filings.



Accounting: Trouble with recent Virginia land purchase

WCI may have gotten more that it bargained for in its recent gamble on a $38.6 million purchase of a 116 acre Fairfax County Virginia property known as Bachman Farm. The property, originally owned by Renaissance Housing Corp., acquired by WCI earlier this year, was purchased by WCI at a large premium in the anticipation of a re-zoning that would increase the building density at the site. Currently zoned for 1 home per two acres, the property's current assessed value is $225,000 per lot. In February however, WCI paid $742,700 per lot in a sale that "reflects anticipated rezoning" according to the county's records.

Fairfax County has set up a committee to study the rezoning proposal and is calling it the Hunter Mill Special Study. There are several proposals before the committee but WCI's is clearly the most aggressive with its intended plans. The gamble may have hit some serious snags however, as just last Friday (August 12th), the news surfaced in a Times Community Newspaper ("Asbestos May Cause Problems", Beverly Crawford, August 9, 2005), that a large band of "naturally occurring asbestos", also called "orange soil" exists on the Bachman Farm property. A WCI representative expressed surprise at hearing the asbestos news, indicating that he was not aware of even the existence of orange soil on the property. It seems that, in addition to the "naturally occurring asbestos" on the site, additional asbestos was brought into the site in 2000 by a private contractor and was stockpiled there.

In the midst of all this is Renaissance Housings former owner, Sonny Small, who now heads up WCI's Mid-Atlantic region and did not return calls placed to him by The Times Community newspaper who published the article revealing the contamination. We have contacted an expert in the field who outlined to us the procedures that would need to be gone through before this matter is clarified and the property might be ultimately improved:

- Environmental Impact Assessment – six to nine months
- Phase 1, and possibly Phase 2 Environmental studies – four months if both required
- Identification of liable party and related potential litigation
- Contracting for removal of the asbestos

Given the fact that the use intended for the property is residential, the highest standard of clean-up will have to be adhered to. So now WCI is faced with a situation where it may have significantly overpaid for a parcel of property that may very well be tied up in litigation and environmental issues for a long time. Clearly, any return on the investment could be significantly delayed.