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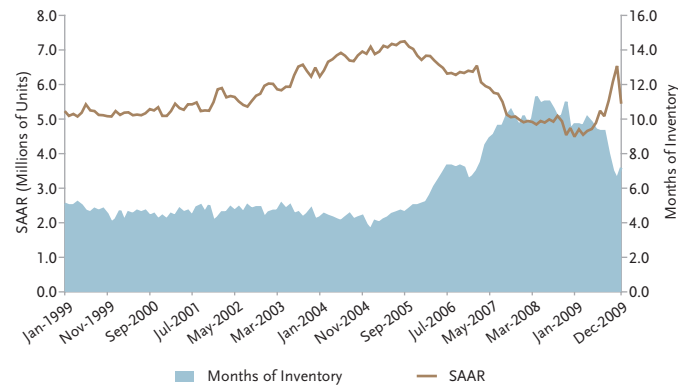
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U.S. Fixed Income

Housing in 2010: Reading the Homebuilding Tea Leaves

The U.S. housing market finished 2009 by providing mixed signals to fixed income investors. On the positive side, the seasonally adjusted annual rate for existing home sales in December increased 15% over the prior year to 5.5 million, after increasing 44% in November. And the inventory of existing homes for sale declined from 3.7 million in the prior year to 3.3 million, bringing the supply of homes down from 9.4 months to 7.2 months based on the current rate of sales.

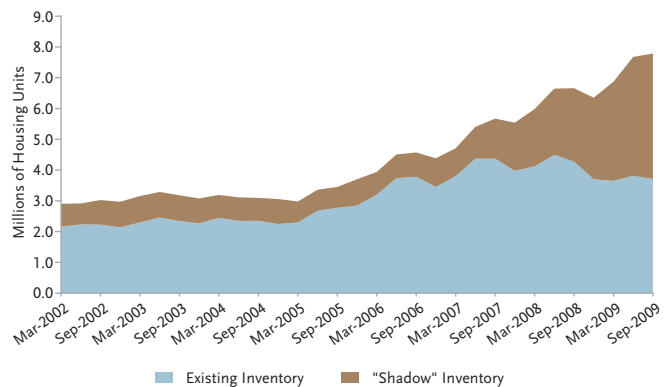
However, the effects of government intervention and non-reported data are not yet fully known. Accounting for “shadow inventory,” or those homes that may soon be for sale due to delinquency and foreclosure, the inventory of existing homes for sale could actually range from five to eight million by some estimates, which would take 11 to 17 months to clear at the current rate, well above the historical median of approximately six months.

U.S. Existing Home Market



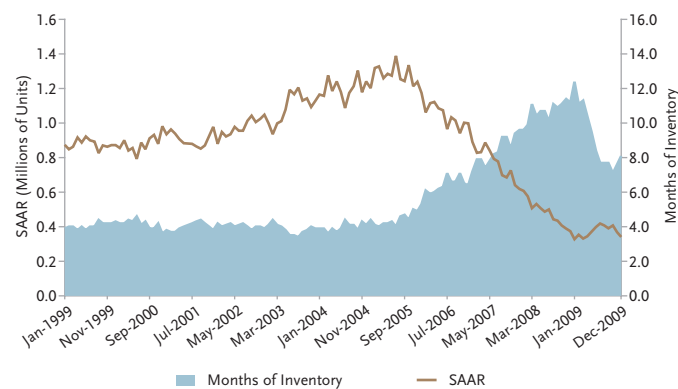
Source: Bloomberg, Nat'l Association of Realtors

U.S. Existing Homes “Shadow” Inventory



Source: Bloomberg, Nat'l Association of Realtors, MBA

U.S. New Home Market



Source: Bloomberg, U.S. Census Bureau

And while the existing home market appears to be stabilizing, at least on the surface, the market for new homes continues to shrink. The seasonally adjusted annual rate for new home sales in December declined 8.6% year-over-year to 342,000. The divergent signals provided by the underlying market data can elicit different strategies not only from investors, but also from the very companies who are engaged in the building and selling of houses. For example, the operating strategies adopted by two of the largest publicly-traded homebuilders, M.D.C. Holdings (MDC) and Hovnanian Enterprises (HOV), imply two very different forecasts for the year ahead.

In December, MDC applied to the SEC to become exempt as an investment company as defined by the Investment Company Act of 1940 for at least one year. With \$1.6 billion of cash and cash equivalents on its balance sheet, MDC is seeking to generate higher returns by shifting its investment portfolio away from government securities toward higher yielding mutual funds. Since MDC's cash position represents greater than 40% of the company's total assets, MDC is required to invest mostly in low-risk, low-yield government securities in order to remain in compliance with Section 3(a)(1)(C) of the Act. MDC is requesting exemption to this rule as a matter of "prudent financial management." As such, MDC is clearly willing to assume additional risk in order to generate higher returns on its assets, but not in its primary business of building and selling houses.

MDC has a relatively cautious inventory development policy and is consequently one of the only homebuilders to retain investment grade ratings at all three major ratings agencies. With operations in 11 states, including some of the biggest housing bubbles in Nevada, Arizona, California, and Florida, MDC targets a supply of land inventory below two years and generally purchases only lower-risk finished lots. However, despite conservative financial management, MDC has struggled operationally alongside the other homebuilders. MDC's home closings decreased from 15,307 in 2005 to 1,904 year-to-date in 2009. The average selling price on MDC's homes, which are generally targeted toward first-time buyers, decreased from \$374,000 in 2005 to \$282,000 year-to-date in 2009. As a result, MDC's total revenues have declined over 85% since 2005.

In response to the downturn MDC decreased expenditures for land purchases from \$1 billion in 2005 to \$0 and simultaneously liquidated its housing and land inventories, which decreased from \$3.0 billion in 2005 to \$503 million as of September 2009. Roughly half of the overall inventory decrease was due to liquidations while the other half was due to asset write-offs. The liquidations served to convert inventory to cash and, with no new investments, resulted in an increase to MDC's cash position from \$215 million in 2005 to \$1.6 billion as of September 2009. Consequently,

MDC's balance sheet looks very different from four years ago: inventory as a percentage of total assets decreased from 79% to 22%, while cash increased from 6% to 69%. The income statement looks different, too, with a higher percentage of revenue derived from investment assets rather than homebuilding operations.

With these disclosures, MDC seems to have determined that the best use for much of that cash is in fixed income mutual funds. The company considered three alternatives to seeking exemption: 1) invest in more land positions; 2) continue investing in low-yielding government securities; or 3) repay debt. The company concluded that all three alternatives are "impractical." For one, MDC "has not to date found [land] opportunities attractive enough to warrant a substantial commitment from its cash assets." Management noted at recent industry conferences that it has "started the process" of rebuilding its land position, though in a minimal way. Two, the effective yield on MDC's portfolio of marketable securities has declined from roughly 5.0% at the beginning of the housing downturn in 2006 to 0.5% currently, which is significantly below MDC's weighted cost of debt of 5.7%. And, three, MDC is unwilling to repay debt because it would forfeit its abundant liquidity and the security that provides during a time of heightened uncertainty.

In contrast to MDC, Hovnanian's recent actions convey a more encouraging sign for the housing market. Hovnanian focuses on multiple customer segments including first-time buyers and first-time move-up buyers. And, similar to MDC, Hovnanian has struggled during the downturn with home closings and revenues down roughly 70% since 2005. Hovnanian, however, has not accumulated a similar liquidity position. While both companies finished 2005 with approximately \$200 million of cash, Hovnanian currently has less than \$600 million, or roughly one third of MDC's \$1.6 billion position. One important reason for the difference in financial profiles is that Hovnanian has used cash to re-invest in land for its homebuilding business. On a recent conference call Hovnanian said that it is "finally seeing land deals that make sense" and disclosed that the company purchased or optioned 4,000 additional lots of land during its recent fiscal quarter. It also

indicated that the expected \$285 million in tax refunds to be received this quarter will likely be used to “reload some land near the bottom of the cycle.”

Could MDC and Hovnanian really be expecting such different scenarios? That is unlikely. One could persuasively argue that Hovnanian’s strategy is borne of necessity. With depleting resources and ongoing demand destruction for its core products, Hovnanian is a CCC-rated company at all three agencies. The credit default swap market assigns a 58% cumulative five-year probability of default to Hovnanian compared to 9% for MDC. Hovnanian’s management would therefore presumably have incentives to embrace more aggressive tactics. But Hovnanian has

also recently repurchased debt on the open market and refinanced near-term debt maturities, both of which are prudent financial actions of a company with an eye toward the longer term.

Thus, market data, which is improved but still depressed, coupled with such divergent operating strategies of homebuilders warrant a cautious approach to the housing market for fixed income investors over the coming year. And, similar to MDC, corporate bond investors may conclude that higher risk-adjusted returns can be earned by allocating long capital to sectors other than homebuilding.

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