

**MARKET SIGNALS
REVIEW**

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Market Signals Say Yes, There Still Is a Homebuilders Sector

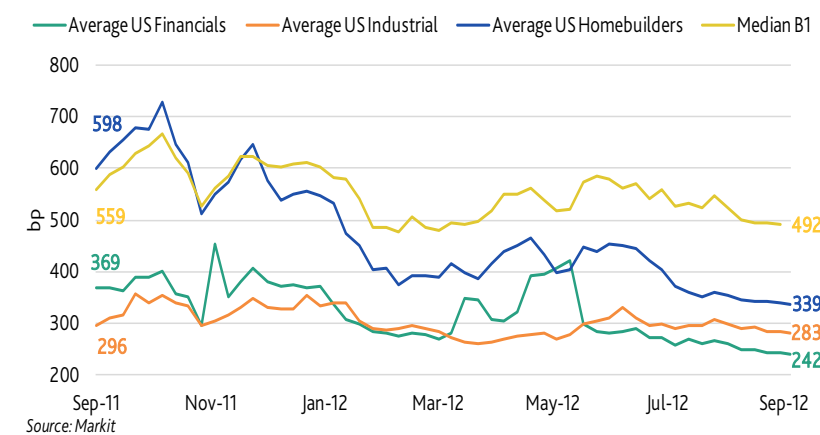
Homebuilders' market signals outperform as the real-estate market shows signs of revival

The market responded positively to recent upbeat news in the real estate sector, and all three market-implied ratings progressed significantly for the average homebuilder compared to the same time last year. Encouraged by record-low mortgage rates and cheap home prices, buyers are looking for opportunities again. Rising private home sales and prices have signaled improvement in the sector lately and some industry observers are even calling it a potential bottom. Market signals indicate that investors agree.

Compared to the B1 level of a year ago, the average CDS-implied rating for the peer group¹ of US homebuilders with market-implied ratings is now two notches higher at Ba2. This widened the average CDS-implied rating gap from 0 to +2 notches. When an implied rating improves, and a positive implied ratings gap widens, the underlying securities have outperformed the broad market.

The five-year median CDS spread for this peer group plunged from around 598 bp in September 2011 to 339 bp at present, or 43%, and the CDS-spread for every company in the peer group fell. By contrast the average CDS-spreads for US financials, US industrials, and the median B1 rated companies remained mostly flat (Figure 1). Standard Pacific performed the best in the CDS market last year, its CDS-implied rating improving by four notches, from B3 to Ba2. The other nine² companies' CDS-implied ratings rose between one and three notches.

Figure 1. Average CDS-spreads vs. the B1 median



¹ See figure 3 for a list of US homebuilders peer group

² M/I Homes, Inc. does not have reliable CDS-spread data.

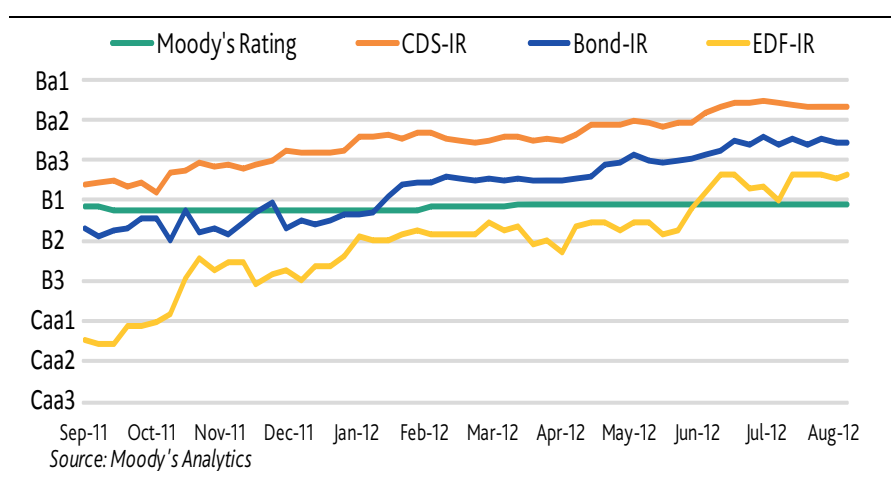
Homebuilders' bond-implied ratings exhibit the same pattern of outperformance. The average bond-implied rating of Ba3 is two notches higher than last year's level of B2. Standard Pacific emerged as the year's best performer here as well, its bond-implied rating rallying most of all, by five notches, from Caa2 to Ba3. The worst performer was M.D.C Holdings, whose bond-implied rating was unchanged from last year at Baa3.

The equity market seems even more optimistic. The average EDF-implied rating in the peer group escalated by four notches in the last 12 months, from Caa1 to Ba3, and the EDF-implied rating gap moved from -3

notches a year ago to +1 currently. The peer group average EDF™ metric, from which the EDF-implied rating is derived, declined (improved) by a whopping 594 bp in this timeframe, from 7.45% to 1.51% (Figure 2).

Eight of the 11 homebuilders in the group have positive market-implied rating gaps for all three market signals (Figure 3). This market view of the sector is unusually bullish, considering that of the 660 companies with all three market-implied ratings in Moody's dataset, only 113, or 17%, have such a robust set of gaps.

Figure 2. Average Moody's and market-implied ratings for homebuilders



Economic indicators show home sector improvement is relative

On August 23 the Federal Housing Finance Agency reported the biggest quarterly jump in housing prices in more than six years, going back to the fourth quarter of 2005. US house prices rose by 1.8% on a seasonally adjusted basis in the second quarter of 2012 compared to the first quarter³, and by 3.0% compared to the same quarter last year. Confirming the trend, on August 28 the S&P/Case-Shiller Home Price Index showed that the national composite was higher by 1.2% in 2Q 2012 versus 2Q 2011, and 6.9% higher than 1Q 2012.

In a separate report on August 23, the Department of Commerce reported seasonally adjusted single-family new home sales for July of 372,000, a 3.6% increase over June and a 25.3% increase over the July 2011 estimate of 297,000. However, despite the increase, sales remain lackluster compared to historical levels. Since 1963 new home sales have averaged 670,000 units per year, and at 372,000 they are only marginally higher than last year, which was the worst year on record with sales of just 306,000.

Moody's Investors Service (MIS) also put these numbers in perspective. In its industry outlook from September 2011, MIS commented that Moody's will consider changing its outlook for the US homebuilding sector from stable to positive when MIS's forecasts show single family housing starts reaching an annualized pace of 800,000 units and new single-family home sales reaching a rate of 650,000 units⁴. MIS's most recent projection was in April when it projected 330,000 new home sales for 2012⁵.

³ As calculated by the FHFA house price index which uses home sales prices from Fannie Mae and Freddie Mac mortgages.

⁴ See Moody's September 29, 2011 Industry Outlook: Going Nowhere Fast

⁵ See Moody's April 19, 2012 Industry Outlook: Risks Remain for US Homebuilders, Despite Strong Projected Revenue Growth in 2012.

Figure 3. US homebuilders market-implied ratings year-over-year, sorted by current CDS spread

Company	Outlook	Moody's Rating		CDS-Implied Rating		Bond-Implied Rating		EDF-Implied Rating		CDS Spread (bp)	
		9/4/12	9/1/11	9/4/12	9/1/11	9/4/12	9/1/11	9/4/12	9/1/11	9/4/12	9/1/11
AVERAGE		B1	B1	Ba2	B1	Ba3	B2	Ba3	Caa1	336	598
Toll Brothers, Inc. ¹	STA	Ba2	Ba2	Baa2	Ba1	Baa3 ¹	Ba1 ¹	Baa2	B2	146	264
M.D.C. Holdings, Inc.	STA	Baa3	Baa3	Baa2	Ba1	Baa3	Baa3	Ba3	Caa1	163	327
D.R. Horton, Inc.	STA	Ba2	Ba3	Baa3	Ba1	Ba1	Ba2	Ba1	B2	188	325
PulteGroup, Inc.	STA	B1	B1	Ba1	B1	Ba1	Ba3	Ba3	Caa2	280	542
Lennar Corporation	POS	B2	B3	Ba1	B1	Ba2	B1	Ba2	Caa1	285	542
Ryland Group, Inc. (The)	STA	B1	B1	Ba1	B1	Ba2	Ba3	Ba3	Caa2	315	517
Meritage Homes Corporation	STA	B1	B1	Ba2	Ba3	Ba3	-	Ba3	Caa2	358	432
Standard Pacific Corp.	POS	B3	B3	Ba2	B3	Ba3	Caa2	Ba3	B3	395	828
KB HOME	STA	B2	B2	B2	B3	B1	Caa1	B3	Caa3	535	789
Beazer Homes USA, Inc.	STA	Caa3	Caa2	B3	Caa2	Caa1	C	Caa2	Ca	695	1,412
M/I Homes, Inc.	STA	Caa1	Caa1	-	-	B2	Caa1	B3	Caa3	-	-

¹Bond-implied rating for Toll Brothers Finance Corp.

- No available data

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