

Getting back to basics - bullish on start of new cycle

Volume expansion will continue to lead with price to follow

We are initiating coverage on the homebuilding industry with seven Buy, one Neutral and one Underperform rating as we think a sustained recovery is now within a reasonable discounting period for the stocks. Our bullish view is partially predicated on 2010 growth in GDP, vehicle sales, employment and stable inflation trends as expected by the BofA Merrill Lynch Economics team, which are the factors that we have identified as most correlated with the homebuilding industry. We are modeling home delivery growth of 8% for the builders in 2010, which could prove conservative relative to the 37% increase in starts as modeled by our economics team and the typical 45% improvement in starts during the first full year of past recoveries. Home sales have historically led pricing by 1-2 years so we do not expect price growth to be a benefit until 2011 at the earliest.

Road to recovery thus far has taken a familiar path

Homebuilding cycles historically have lasted six years with an even split between the upswing and downswing phases. The decline in the most recent cycle lasted three years and the upturn has thus far brought a 28% growth in housing starts, which is consistent in timing and magnitude with past recoveries. We recognize that government stimulus has played more of a role in the current cycle than in past recoveries, although we expect a fairly smooth transition from public sector support to organic growth due to improving economic conditions. Foreclosures will continue to weigh on pricing for at least the next year, although we think volume growth should generally be insulated for several reasons.

Staying light on your feet offers best risk adjusted returns

Most companies are moving toward land light models that require faster inventory turns, which we think makes sense as companies holding significant land positions have never been able to demonstrate consistent outperformance in risk adjusted returns on capital. Most companies will face the need to purchase land soon irrespective of current supply as legacy land holdings may not be conducive to the quick turn model. Share gains by the largest builders in the first-time and first move-up markets are also aligned with the quick turn strategy.

Cash discount and returns upside drive valuation model

Our valuation is based on a returns driven framework as returns on equity and invested capital have the most predictive value for homebuilding stocks in our opinion. We expect returns to improve for every company other than TOL during 2010 and builders with the highest relative improvement in returns should achieve meaningful multiple expansion. We also think HOV, KBH and MDC should exhibit upside as their equity values are below current cash value, which we have defined as cash on the balance sheet and the present value of deferred taxes. The multiple expansion that we anticipate should result in P / Tangible BV of 0.7x versus 0.3x currently and 0.9x historically and EV / Invested Capital of 1.1x, which is in line with both current levels and the historic average.

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Refer to important disclosures on page 46 to 48. Analyst Certification on Page 44. Price Objective Basis/Risk on page 42.

Equity | United States | Homebuilders and Building Products
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Table 1: Ratings Distribution

Symbol	BofAML Rating	Ratings Distribution		
		Buy	Neutral	Sell
DHI	Buy	5	10	3
HOV	Buy	0	4	5
KBH	Buy	5	9	2
LEN	Buy	9	4	1
MDC	Buy	5	2	0
PHM	Buy	2	10	1
RYL	Buy	2	7	0
BZH	Neutral	0	4	1
TOL	Underperform	8	8	1
		36	58	14

Source: BofA Merrill Lynch Global Research Estimates, Bloomberg

Table 2: Price Objectives

Symbol	Price Objective	Current Stock Price	% Change from Current Price
DHI	16	13.22	20%
HOV	5	3.96	39%
KBH	20	16.97	22%
LEN	21	17.34	21%
MDC	43	35.37	23%
PHM	14	11.66	17%
RYL	28	23.73	20%
BZH	4.50	4.45	4%
TOL	16	20.05	(17)%

Source: BofA Merrill Lynch Global Research Estimates

Investment thesis

Table 3: Company Coverage and Ratings

Company Name	Symbol	Market	
		Capitalization (\$ Millions)	BofA/ML Rating
DR Horton	DHI	4,107	Buy
Hovnanian Enterprises	HOV	300	Buy
KB Home	KBH	1,650	Buy
Lennar	LEN	3,136	Buy
MDC Holdings	MDC	1,656	Buy
Pulte Homes	PHM	4,469	Buy
Ryland Group	RYL	1,019	Buy
Beazer Homes	BZH	172	Neutral
Toll Brothers	TOL	3,273	Underperform

Source: BofA Merrill Lynch Global Research Estimates

Our bullish view on the homebuilding industry is based on an expectation of volume growth in 2010 driven by improving economic conditions, which should more than offset any drag from the fading out of government stimulus programs. We are initiating coverage with Buy ratings on seven of the nine companies in our coverage universe as our analysis suggests that stock price performance for the industry is highly correlated in the first two years of economic recoveries. History would therefore suggest that the stocks should continue to track closely together through at least 2010, which may be followed by some dispersion of returns in 2011 and beyond that warrants more selectivity. To the extent that investors do not want to use an indexed approach over the next year, our top ideas include DHI due to anticipated volume growth and an efficient cost structure, HOV due to an excessive valuation discount for its capital structure and MDC due to its land acquisition strategy and valuation currently below cash value.

Our estimates assume 8% home delivery growth this year, which is well below the 37% growth in housing starts forecasted by the BofA Merrill Lynch Economics team and the typical 45% increase in starts during the first year of a recovery (please refer to the glossary at the back of this report for definitions of terms). This difference can be explained by our desire to be more conservative regarding the potential impact of foreclosures and mortgage delinquencies on overall housing demand and the precise timing of sustained economic growth. Pricing will remain under pressure due to foreclosures' impact on the appraisal process and a mix shift toward smaller homes that are better suited to first-time buyers, which continues to be the most favorable segment of the market. We expect pricing and volumes to accelerate in 2011 as the recovery fully takes hold, although single family starts should still be below a normalized level during that year.

Table 4: Unit and Price Forecasts for Homes Delivered

Company	Y/Y % Change in Home Sales				Y/Y % Change in Homes Delivered (Units)				Y/Y % Change in Homes Delivered (Price)			
	FY 2009	FY 2010 E	FY 2011 E	FY 2012 E	FY 2009	FY 2010 E	FY 2011 E	FY 2012 E	FY 2009	FY 2010 E	FY 2011 E	FY 2012 E
BZH	(47)%	3%	13%	10%	(43)%	8%	10%	7%	(7)%	(5)%	3%	2%
DHI	(42)%	11%	8%	8%	(37)%	17%	4%	5%	(9)%	(5)%	3%	3%
HOV	(52)%	2%	10%	8%	(49)%	4%	7%	6%	(5)%	(2)%	2%	2%
KBH	(40)%	2%	12%	10%	(32)%	8%	9%	8%	(12)%	(5)%	3%	2%
LEN	(35)%	7%	13%	12%	(27)%	9%	10%	9%	(11)%	(2)%	3%	3%
MDC	(38)%	8%	12%	11%	(32)%	10%	9%	8%	(9)%	(2)%	3%	3%
PHM (1)	(50)%	2%	10%	9%	(48)%	4%	7%	7%	(5)%	(2)%	3%	2%
RYL	(34)%	8%	12%	10%	(30)%	10%	9%	8%	(5)%	(2)%	3%	2%
TOL	(44)%	(19)%	7%	11%	(37)%	(15)%	3%	6%	(11)%	(6)%	4%	4%
Industry Average	(44)%	3%	10%	10%	(39)%	8%	7%	7%	(8)%	(3)%	3%	3%

(1) 2009 data for PHM reflects estimated results based on PHM and CTX being combined for the full year

Source: Company Reports and BofA Merrill Lynch Global Research Estimates

Most builders should achieve margin expansion during 2010 driven by volume growth and an emphasis on production efficiencies that enhance profitability on smaller square footage homes desired by first-time buyers. Margin improvement should accelerate in 2011 once price becomes a contributor. Our expectations appear reasonable given that the 630bp of aggregate gross margin upside we are modeling for the industry for 2010-2012 will only place margins in line with the 19% historic average. Margin improvement will translate into higher returns on equity and invested capital, which drive our valuation framework. This upside should yield multiple expansion, although valuation will still be toward the lower end of historic ranges for most companies if our price targets are achieved.

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Table 5: Gross Margin (Excluding Impairments) Forecasts

Company	Gross Margin (Excluding Impairments)					Y/Y Change (bp)			
	FY 2008	FY 2009	FY 2010 E	FY 2011 E	FY 2012 E	FY 2009	FY 2010 E	FY 2011 E	FY 2012 E
BZH	9%	11%	13%	17%	18%	262	197	318	120
DHI	11%	13%	17%	19%	21%	205	352	267	152
HOV	3%	4%	6%	9%	11%	60	189	326	180
KBH	10%	13%	15%	18%	20%	254	222	320	125
LEN	17%	15%	17%	20%	22%	(154)	204	282	138
MDC	13%	18%	19%	22%	23%	531	149	271	114
PHM	7%	11%	14%	17%	19%	373	392	283	137
RYL	10%	9%	12%	15%	16%	(46)	220	341	105
TOL	21%	15%	14%	16%	18%	(611)	(131)	193	226
Industry Average	11%	12%	14%	17%	19%	97	199	289	144

Source: Company Reports and BofA Merrill Lynch Global Research Estimates

A view from the bull camp

Economic outlook points to better days ahead

The homebuilding industry has been closely tied to economic activity with GDP, lightweight vehicle sales, non-farm payroll employment and CPI carrying the most predictive value. The BofA Merrill Lynch Economics team is forecasting growth of 3.1% for United States GDP and 17.3% for lightweight vehicle sales in 2010. This trajectory is basically in line with the first year of recovery coming out of past downturns, which has historically coincided with a 45% growth rate in housing starts. We are modeling less than 10% delivery growth in aggregate for all eight companies in our coverage universe so our estimates could prove conservative if the rate of recovery in 2010 is directionally consistent with history.

Path of recovery has followed history thus far ...

Housing downturns have typically lasted three years with a 44% decline in starts on average. The subsequent upturn has been a similar duration and has resulted in a doubling of starts off of the bottom. The decline that began in 2006 reached a trough around the three year mark in January 2009 and so far the recovery has been in line with the typical first year rate of improvement. Although there are factors that could make this cycle different, applying the historic rate of progression implies that starts could increase 24% in each of the next two years. This growth would only put single family starts at 700k by the beginning of 2012, which would still be below our normalized estimate of 900k. Under this growth scenario, total starts (including multi-family) would be 870k by 2012 versus our normalized estimate of 1.2mn.

... but stocks are not getting the benefit of the doubt

Although the homebuilding stocks have appreciated 88% from the lows of 2009, the pace of recovery (both in absolute and market relative terms) has been more modest than during past upturns. Investor doubt also is reflected in the fact that all but one company trades below historic price / tangible book value multiples (net of cash) and four companies currently trade below cash value. Our returns based framework suggests every builder other than TOL should achieve multiple expansion during 2010 that will still put group valuation below historic averages.

Embracing the right model regardless of where cycle stands

We think limiting land ownership (asset light model) makes sense irrespective of the point in the cycle given that returns on capital for asset heavy companies have never been consistently above those of asset light companies when adjusted for the risk of deploying capital. The asset light model requires a higher sales velocity, which is conducive to the early phase of a recovery (such as now) given that volumes lead pricing by 1-2 years. The first-time buyer currently offers the greatest potential for velocity given affordability and government stimulus programs, which explains why many builders with an asset light mindset have been targeting the first-time market. Most builders (except TOL) have embraced the asset light model to varying degrees, which we believe is the right strategic approach even once lower velocity markets (move-up and active adult) start to improve.

Capital structure concerns are largely off the table

Debt / capital for the industry is now 67%, which is above the 54% historic average. In contrast, net debt / capital is 15 percentage points below the historic level of 48% given the cash that these companies have been building through land sales, working down existing inventory, reducing dividend payments and

eliminating share repurchases. These cash positions will be further enhanced by the receipt of federal tax refunds in early 2010. Most companies with high leverage (BZH, HOV and KBH) do not face significant maturities over the next few years and therefore liquidity concerns should generally not factor into equity valuations at this point (other than for BZH). Equally as important, we think most builders have a capital structure that allows for operational flexibility to acquire land as demand trends improve.

Survival of fittest works in favor of largest builders

The largest public builders account for 27% of the market and we expect that share to continue to increase given the lack of capital available to smaller builders and financial sponsors. These share gains will be concentrated in the first-time and first move-up markets because these segments are the focus of the larger builders. Private builders tend to be more geared to the luxury segment, which remains under pressure. Limited competition has allowed the large builders to begin purchasing land on more attractive terms, which is reflected in the use of rolling option contracts during this cycle that were not as prevalent coming out of past downturns.

A view from the bear camp

Foreclosures are thorn in side of pricing and impairments

More than 14% of residential mortgages in the United States are currently at risk (past due or in foreclosure process), which is unprecedented and equates to as much as 15 months of home sales. In addition, our analysis suggests that 3-4mn already foreclosed homes may be held by financial institutions, which equates to another 9-10 months of sales at the current pace. Foreclosures should continue to weigh on new home prices given the impact that these properties have had on the appraisal process, although we do not anticipate as much of a drag on sales volumes given a number of disincentives. Pricing could drive operating leverage for the builders beginning in 2011, although that may prove optimistic if a large portion of foreclosed properties go on the selling block at the same time. The impact of foreclosed properties on pricing will also lead to continued impairments of existing land holdings, which we expect to be a factor through mid 2011.

Government stimulus impact will be uncertain until gone

The government has become increasingly involved in the homebuilding market during this downturn through tax credits, mortgage modifications, purchases of mortgage backed securities and the prevalence of the Federal Housing Administration in the mortgage underwriting process. The incremental impact of these initiatives has been difficult to gauge, although the market will face its first test over the next few months as the securities purchases (end of March) and tax credits (end of June) are scheduled to terminate. We would not be surprised if some demand lull materializes once the tax credit expires (accounted for an estimated 12-14% of total home sales during 2009) and our analysis suggests that a 100bp increase in mortgage rates would yield a 50k decline in new home sales (374k was total for 2009). Having said that, a pick up in organic growth should mitigate these factors on a full year basis. The mid-term elections taking place at the end of 2010 also suggest that the government has an incentive to remain accommodative to ensure stability in the housing market.

Value buyer appears to be the only game in town for now

The first-time and first move-up markets collectively account for almost 80% of revenues for the largest builders versus a mix of 50-60% historically. This concentration is partially a function of government stimulus programs, the lack of a legacy residence to be sold before moving (in the case of first-time customers)

and persistent challenges in the active adult and luxury markets. We think the luxury segment will remain under particular pressure given that mortgage market liquidity remains limited for loans exceeding \$730k in higher cost areas of the country. A desire to gain outsized share in the first-time and first move-up markets could result in price competition amongst the largest builders that limits the margin benefit from increased volumes during 2010. We also think an increasing shift toward the first-time segment will weigh on reported pricing during 2010 as these homes carry lower per unit prices than other product lines.

Land purchases will be a reality irrespective of holdings

We expect most builders to generate some cash flow benefit during 2010 from selling homes but the need to replenish holdings of attractively positioned lots could weigh on cash flow beginning in 2011. The average years of land supply in the industry is 6.4 currently (based on trailing 12 month deliveries), although a large portion of those holdings may be in locations that are not conducive to the asset light model. Builders may be faced with ramping up purchases of lots that can be converted into home sales quickly and therefore we expect changes in inventory to create a cash flow drag for most builders in 2011. The need to prepare existing lots for home construction could also become a cash drain as only 43% of land currently held is in a finished state. We do not expect the need for land to drive a wave of mergers between builders as ample lots seem to exist that can be purchased through option contracts, which is a lower risk strategy.

Certain efficiency gains will be temporary at best

Many builders have focused on production efficiencies during this downturn by sourcing materials nationally and reducing production times. Materials account for 30% of the cost to build a home and we think some of the purchasing efficiencies achieved will prove to be sustainable. In contrast, efforts to reduce labor costs (23% of construction expenditures) such as through even flow production will likely prove to be short term at best. The limited benefit is due to the exclusive use of subcontractors for home construction as these laborers gain more negotiating leverage with the homebuilders when business picks up. The net result is that some of the margin benefit that has been achieved during the downturn will be given back in the coming upturn, although price and volume gains will be mitigating factors.

Table 6: Key Metrics by Company

Symbol	Buyer Profile (2)				Product Profile (2)				Material Joint Ventures (6)	Largest Region Based on Revenue (1)	Average Price of Homes Sold (2)	Speculative Units as % of Backlog (2)	Years of Land Supply (Deliveries) (1)	% of Lots Owned (2)	Gross Margin (2) (5)	SG&A Expense as % of Total			Debt / Capital (2) (4)
	First-Time	Move-Up	Second Move-Up / Luxury	Active Adult	Single Family Detached	Multi-Family	Urban In-fill and High-Rise	Mortgage Business Insourced								ROIC (2) (5)	ROE (2) (5)		
BZH	64%	36%	0%	0%				No	East	227.3	58%	7.9	85%	13%	21%	(3)%	(9)%	86%	
DHI	50%	40%	6%	4%	88%	12%	0%	Yes	South Central	200.4	176%	6.8	81%	17%	11%	0%	(2)%	53%	
HOV	43%	28%	18%	11%	83%	14%	3%	Yes	Southwest	287.1	37%	5.2	59%	6%	19%	(6)%	(17)%	124%	
KBH	80%	10%	0%	10%	95%	5%	0%	No	West Coast	205.9	13%	4.3	76%	12%	13%	(1)%	(2)%	72%	
LEN	50%	50%	0%	0%	95%	5%	0%	Yes	West	239.2	169%	7.9	92%	16%	18%	(0)%	(0)%	53%	
MDC	50%	50%	0%	0%	96%	4%	0%	Yes	West	268.4	65%	3.0	71%	19%	20%	(1)%	(3)%	49%	
PHM	30%	30%	10%	30%	75%	25%	0%	Yes	Gulf Coast	257.6	22%	7.5	89%	14%	11%	(1)%	(1)%	57%	
RYL	59%	27%	14%	0%	80%	20%	0%	Yes	North	237.3	25%	3.9	80%	13%	9%	(2)%	(3)%	60%	
TOL	0%	0%	88%	12%	60%	28%	12%	Yes	North	565.8	24%	10.8	84%	14%	18%	(1)%	(1)%	46%	
Average	47%	30%	15%	7%	84%	14%	2%			276.6	66%	6.4	80%	14%	15%	(2)%	(4)%	67%	

(1) Trailing 12 months

(2) Most recent quarter

(3) Reflects F2009

(4) Homebuilding only where available

(5) Excludes impairments

(6) Material is defined as having investments in unconsolidated entities exceeding \$30mn

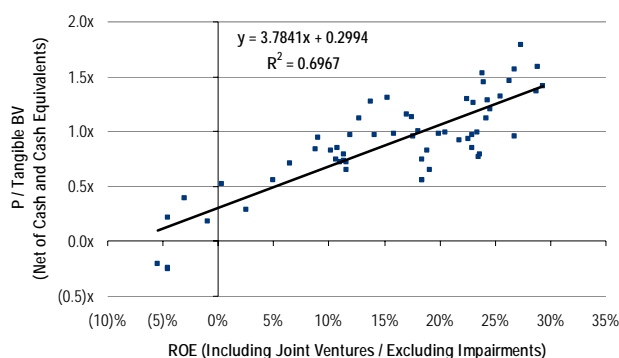
Source: Company Reports and BofA Merrill Lynch Global Research Estimates

Identifying the valuation drivers Returns appear to trump growth

We have identified returns on equity and invested capital as the most predictive measures for equity valuation, which drives our price target calculations

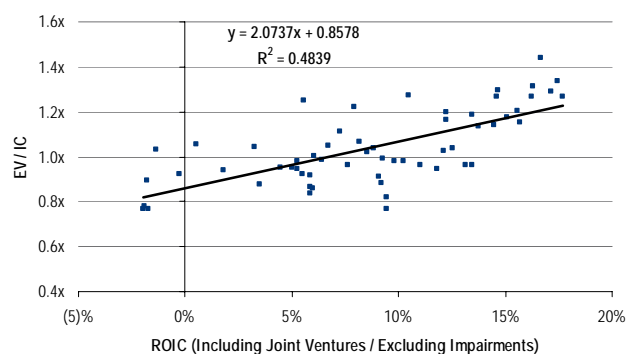
Our valuation framework is based on returns on equity and invested capital as the most important gauges of operating performance. These gauges should be predictive of equity valuation, which is reinforced by our correlation analysis. We have identified price / tangible book value (P / TBV) (net of cash and equivalents) as being positively correlated with return on equity (ROE) and enterprise value / invested capital (EV / IC) as being tied to return on invested capital (ROIC). In both relationships, higher returns should yield a higher multiple so our returns forecasts dictate the appropriate multiple as opposed to just basing our valuation work on historic ranges.

Chart 1: Industry Scatter Plot of P / TBV versus ROE for 1995 - 2009



Source: Company Reports and BofA Merrill Lynch Global Research Estimates

Chart 2: Industry Scatter Plot of EV / IC versus ROIC for 1995 - 2009



Source: Company Reports and BofA Merrill Lynch Global Research Estimates

Following are the definitions for each component of the framework:

Table 7: Valuation Framework Definitions

Ratios	Acronym	Numerator Definition	Numerator Timeframe	Denominator Definition	Denominator Timeframe
Fundamental					
Return on Equity	ROE	Net Income (Excluding Impairments)	Forward 4 quarters	Shareholders' Equity (Excluding Cumulative Impairments)	Average of forward 4 quarters
Return on Invested Capital	ROIC	Operating Income (Excluding Impairments) * (1 - Normalized Tax Rate) + Income / (Loss) from Joint Ventures	Forward 4 quarters	Total Assets (Excluding Impairments) - Non Interest Bearing Liabilities - 50% * Cash and Cash Equivalents	Average of forward 4 quarters
Valuation					
Price / Tangible Book Value	P / TBV	Stock Price * Shares Outstanding - Cash and Equivalents - Present Value of Deferred Tax Assets	End of current quarter	Shareholders' Equity - Goodwill - Intangible Assets	Average of forward 4 quarters
Enterprise Value / Invested Capital	EV / IC	Stock Price * Shares Outstanding + Net Debt + Preferred Stock + Minority Interest - Present Value of Deferred Tax Assets	End of current quarter	Total Assets - Non Interest Bearing Liabilities - 50% * Cash and Cash Equivalents	Average of forward 4 quarters

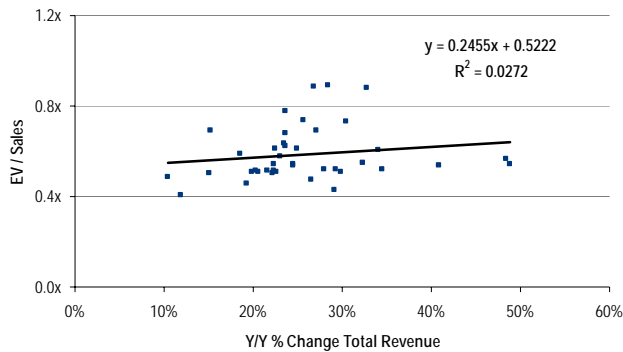
Invested Capital is defined as Total Assets - Non Interest Bearing Liabilities - Excess Cash and we have defined Excess Cash as 50% * Cash and Cash Equivalents given the need to use some cash for land purchases over the next few years
Source: BofA Merrill Lynch Global Research Estimates

Sales and earnings growth rates have not exhibited a close correlation with valuation historically

We stress tested our thesis by looking at the historic correlation between sales and earnings growth rates versus relevant valuation metrics and did not find any meaningful relationships. The correlations still did not exhibit any material combinations when looking at the 1995-2005 timeframe when growth rates showed a more linear trend than the past few years. We therefore believe that our returns based framework carries the most predictive value in terms of identifying the appropriate stock multiples.

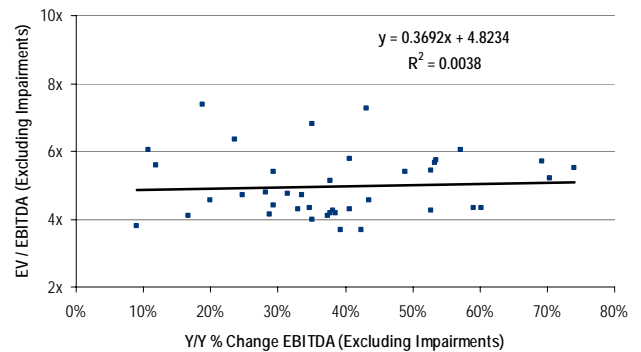
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Chart 3: Industry Scatter Plot of EV / Sales versus Sales Growth for 1995-2005



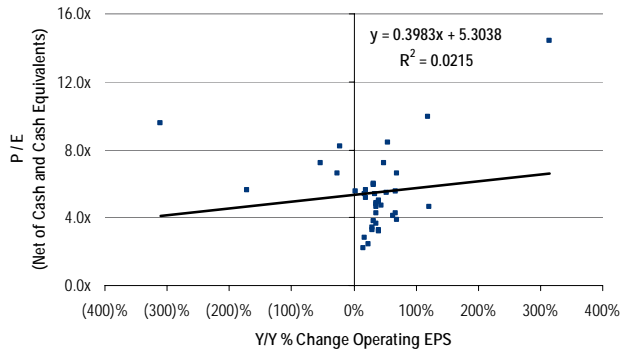
Source: Company Reports and BofA Merrill Lynch Global Research Estimates

Chart 4: Industry Scatter Plot of EV / EBITDA versus EBITDA Growth for 1995-2005



Source: Company Reports and BofA Merrill Lynch Global Research Estimates

Chart 5: Industry Scatter Plot of P / E versus EPS Growth for 1995-2005



Source: Company Reports and BofA Merrill Lynch Global Research Estimates

Our framework suggests model expansion for all companies other than TOL over the next year with appreciation ranging from 4% to 39%

What the valuation model tells us

We expect some multiple expansion for all companies other than TOL, which faces compression due to deteriorating returns on equity and invested capital over the next year. The blended price target is equally weighted between the forecasted price using the comparison of (1) P / TBV versus ROE and (2) EV / IC versus ROIC.

Table 8: Price Target Calculation

Company	Stock Price	Price Target Components			% Change versus Current Stock Price		
		P / TBV vs ROE	EV / IC vs ROIC	Blended Average	P / TBV vs ROE	EV / IC vs ROIC	Blended Average
HOV	3.88	6	5	5	49%	28%	39%
MDC	35.22	44	43	43	24%	22%	23%
KBH	16.62	21	19	20	29%	15%	22%
LEN	16.96	23	18	21	34%	9%	21%
RYL	23.23	29	26	28	27%	14%	20%
DHI	13.07	16	15	16	24%	16%	20%
PHM	11.74	14	13	14	21%	12%	17%
BZH	4.32	5	4	5	5%	4%	4%
TOL	19.87	17	16	16	(16)%	(19)%	(17)%

Source: BofA Merrill Lynch Global Research Estimates

DHI should achieve the most relative improvement in returns and DHI and PHM will be the only companies generating positive returns in the next year based on our estimates

We expect DHI to achieve the most relative improvement in returns over the next year as the company should benefit from volume improvement more so than other builders due to its speculative construction strategy. DHI and PHM will be the only two companies generating positive ROE and ROIC within the next year based on our estimates, although returns will still be well below historic averages.

Table 9: ROIC (Including Joint Ventures / Excluding Impairments)

Company	Most Recent Quarter	Historic (1995 - 2009)		
		Average	Maximum	Minimum
DHI	0.0%	9.5%	17.3%	(0.5)%
LEN	(0.3)%	9.0%	17.5%	0.3%
TOL	(0.5)%	9.6%	20.2%	(0.5)%
PHM	(0.8)%	8.6%	14.7%	(3.0)%
KBH	(0.9)%	8.1%	18.1%	(2.6)%
MDC	(1.4)%	10.2%	21.2%	(2.5)%
Industry Average	(1.6)%	8.7%	17.7%	(2.0)%
RYL	(2.0)%	10.0%	20.8%	(3.0)%
BZH	(2.8)%	7.4%	17.4%	(3.9)%
HOV	(5.6)%	6.4%	18.1%	(6.5)%

Source: Company Reports

Table 10: ROE (Including Joint Ventures / Excluding Impairments)

Company	Most Recent Quarter	Historic (1995 - 2009)		
		Average	Maximum	Minimum
LEN	(0.4)%	17.3%	28.7%	0.3%
TOL	(0.7)%	18.2%	32.4%	(0.7)%
PHM	(1.3)%	14.1%	23.7%	(4.8)%
DHI	(1.5)%	18.6%	29.6%	(1.8)%
KBH	(2.2)%	14.6%	32.2%	(4.4)%
MDC	(2.8)%	16.7%	31.7%	(3.8)%
RYL	(3.3)%	16.2%	32.2%	(4.5)%
Industry Average	(4.3)%	15.8%	29.3%	(5.5)%
BZH	(9.1)%	13.1%	30.7%	(16.5)%
HOV	(16.8)%	13.3%	34.0%	(20.6)%

Source: Company Reports

Table 11: Forecast Y/Y Change in ROIC

Company	Most Recent Quarter	1 Year After Most Recent Quarter	Y/Y Change (bp)	% Improvement
DHI	0.0%	1.7%	171	5640%
LEN	(0.3)%	0.3%	61	182%
PHM	(0.8)%	0.3%	116	143%
RYL	(2.0)%	(0.3)%	166	84%
MDC	(1.4)%	(0.3)%	115	81%
Industry Average	(1.6)%	(0.6)%	97	60%
KBH	(0.9)%	(0.4)%	52	58%
BZH	(2.8)%	(1.6)%	116	42%
HOV	(5.6)%	(5.1)%	47	8%
TOL	(0.5)%	(1.0)%	(47)	(89)%

Source: BofA Merrill Lynch Global Research Estimates

Table 12: Forecast Y/Y Change in ROE

Company	Most Recent Quarter	1 Year After Most Recent Quarter	Y/Y Change (bp)	% Improvement
DHI	(1.5)%	1.4%	296	192%
LEN	(0.4)%	0.4%	84	188%
PHM	(1.3)%	0.1%	146	110%
KBH	(2.2)%	(0.5)%	164	76%
BZH	(9.1)%	(5.7)%	346	38%
Industry Average	(4.4)%	(2.8)%	163	37%
MDC	(2.8)%	(2.2)%	58	21%
HOV	(16.8)%	(15.3)%	153	9%
RYL	(3.3)%	(3.2)%	9	3%
TOL	(0.7)%	(1.2)%	(52)	(72)%

Source: BofA Merrill Lynch Global Research Estimates

Our price targets assume multiple expansion that will still put every builder other than DHI and PHM below historic average valuation

The magnitude of P / TBV and EV / IC multiple expansion results from the expected improvement in returns over the next year, although we also assumed additional upside for some companies that are currently trading below cash value from a P / TBV standpoint. BZH, HOV, MDC and KBH all have market values below the sum of cash and the present value of deferred tax assets (discounted over seven years at 10% except for BZH and PHM). We think builders should be given credit for existing cash and potential tax refunds given that our analysis suggests new investment can yield returns that exceed capital costs. Every builder other than DHI and PHM will carry a multiple that is at or below its historic average even after our expectations for multiple expansion. DHI deserves a scarcity premium given our expectation for market leading improvement in returns while PHM warrants a slight premium given that the company controls its operating leverage destiny more so than peers due to merger synergies.

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Table 13: Forecasted EV / IC

Company	Current	Implied Multiple Based on ROIC	Historic (1995 - 2009)		
			Average	Maximum	Minimum
BZH	0.8x	0.8x	0.9x	1.3x	0.6x
DHI	1.1x	1.3x	1.1x	1.5x	0.7x
HOV	0.9x	0.9x	1.0x	1.5x	0.6x
KBH	1.1x	1.2x	1.3x	1.9x	0.6x
LEN	0.9x	0.9x	1.0x	1.6x	0.5x
MDC	0.7x	0.9x	1.0x	1.4x	0.5x
PHM	1.2x	1.3x	0.9x	1.3x	0.7x
RYL	1.0x	1.1x	1.2x	1.9x	0.7x
TOL	0.9x	0.7x	1.2x	2.0x	0.8x
Industry Average	1.0x	1.1x	1.0x	1.4x	0.8x

Source: Factset and BofA Merrill Lynch Estimates

Table 14: Forecasted P / Tangible BV (Net of Cash)

Company	Current	Implied Multiple Based on ROE	Historic (1995 - 2009)		
			Average	Maximum	Minimum
BZH	(1.6)x	(1.6)x	0.6x	1.9x	(3.1)x
DHI	0.4x	0.7x	0.5x	1.4x	(0.6)x
HOV	(3.1)x	(2.5)x	1.5x	15.5x	(4.4)x
KBH	(0.0)x	0.8x	1.6x	2.8x	(0.9)x
LEN	0.5x	0.9x	1.0x	2.1x	(0.2)x
MDC	(0.1)x	0.3x	0.9x	1.8x	(0.4)x
PHM	0.8x	1.2x	0.8x	1.5x	(0.4)x
RYL	0.2x	0.7x	1.0x	2.4x	(0.0)x
TOL	0.4x	0.2x	1.3x	2.7x	0.3x
Industry Average	0.3x	0.7x	0.9x	1.8x	(0.2)x

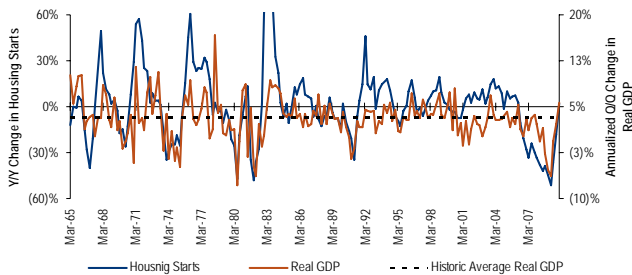
Source: Factset and BofA Merrill Lynch Estimates

Taking a top down view Identifying the macro figures to focus on

Housing starts seem to lead most economic measures and we found that GDP and lightweight vehicle sales have a fairly close correlation with starts

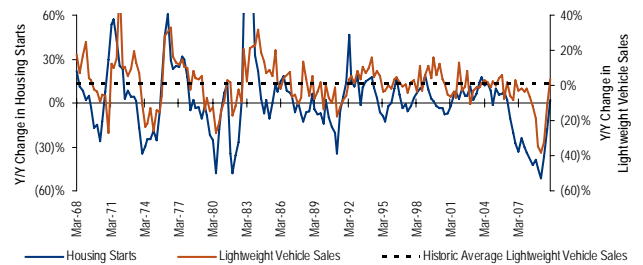
The homebuilding industry now accounts for 2-3% of gross domestic product (GDP) versus 6% at the cycle peak, although we think new home production represents one of the most compelling leading indicators for economic activity. Our regression analysis of more than 100 housing, general economic, employment, consumer and financing variables did not identify many data points that have consistently been a leading indicator for housing starts over the past 50 years. Having said that, we identified four metrics widely forecast by economists that seem to have the closest relationship with the housing industry in terms of coincident changes. Single family housing starts have had the closest correlation with real GDP and lightweight vehicle sales, which makes sense as these measures are a proxy for individuals' capacity and desire to buy a home.

Chart 6: Y/Y Change in Housing Starts versus Real GDP



Housing Starts only include one unit structures
Source: Haver Analytics

Chart 7: Y/Y Change in Housing Starts versus Vehicle Sales

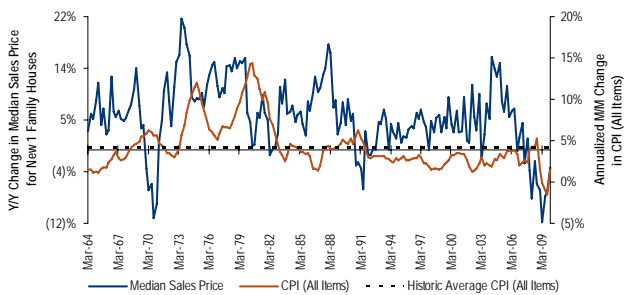


Housing Starts only include one unit structures
Source: Haver Analytics

Home prices appear to have a close relationship with CPI and non-farm employment levels

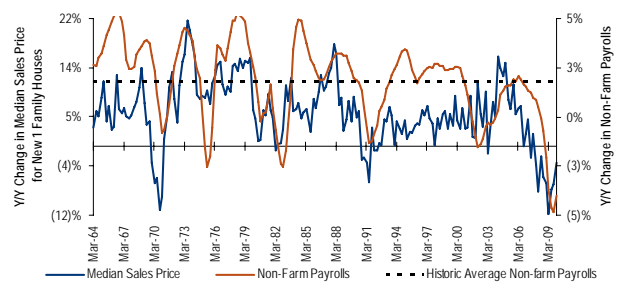
Although home prices tend to lag permits, starts and the number of homes sold, we think price improvement can be confirmation of the sustainability of a recovery. Our analysis has identified the consumer price index (CPI) (including all items) and non-farm payroll employment as the metrics most closely tied to new home prices on a real time basis. Real estate has always been viewed as a hedge against inflation and our work confirms that notion. The correlation with payrolls suggests that employment is the primary driver of what buyers are willing to pay for a house while overall economic activity is more of a factor in the decision to purchase a home at all (as reflected in the correlation with starts).

Chart 8: Y/Y Change in House Prices versus CPI



Source: Haver Analytics

Chart 9: Y/Y Change in House Prices versus Non-Farm Payrolls



Source: Haver Analytics

Housing starts typically exhibit directional consistency with GDP and vehicle sales during the first year of recovery while employment lags behind

We are modeling less than 10% home delivery growth for 2010, which could prove conservative versus the 37% start growth being forecasted by our economics team

We have analyzed how all four of these macroeconomic variables performed coming out of past downturns with the trough being defined as when single family home starts reached a bottom. GDP has typically expanded by 3.7% in the first year of a recovery while lightweight vehicle sales have increased by 11% on average. Non-farm employee growth has been flat, which is not a surprise given that job formation tends to lag economic recoveries. CPI has been 3.4% on average, which is not much different from the rate in years two and three of past recoveries and the normalized rate of inflation. By comparison, single family housing starts have typically increased 45% in the first year of recovery.

Working under the assumption that 2010 represents the first full year of recovery in this business cycle, the forecasts of the BofA Merrill Lynch Economics team make sense in a historical context. Housing start growth of 37% for 2010 could be achievable assuming United States GDP growth of 3.1% and a 17.3% increase in lightweight vehicle sales, although our company specific forecasts assume volume growth of less than 10% in order to be conservative. We also are expecting price declines for the homebuilders during 2010, however there should be upside if the 1.1% employment growth forecast of our economics team ultimately materializes.

Table 15: Single Family Housing Starts and Most Important Macroeconomic Factors at Troughs and in Years 1-3 of Subsequent Recoveries

Troughs	Single Family Starts at Trough	Y/Y % Change in Single Family Starts			Real GDP			Y/Y % Change in Lightweight Vehicle Sales			Y/Y % Change in Non-Farm Employees			Y/Y % Change in CPI		
		Year 1	Year 2	Year 3	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3
Dec-60	841	20%	7%	8%	8%	1%	3%	NA	NA	NA	1%	2%	2%	1%	1%	2%
Oct-66	597	52%	5%	(14)%	3%	3%	3%	NA	17%	3%	2%	3%	4%	3%	5%	6%
Jan-70	596	68%	40%	2%	4%	1%	7%	12%	58%	9%	(1)%	2%	4%	5%	4%	3%
Feb-75	667	88%	20%	2%	5%	3%	1%	28%	13%	10%	(1)%	3%	5%	6%	5%	7%
Oct-81	523	41%	40%	6%	2%	8%	4%	20%	22%	14%	(2)%	1%	5%	4%	3%	4%
Jan-91	604	60%	13%	4%	2%	4%	5%	3%	8%	10%	(1)%	1%	2%	3%	3%	3%
Mar-95	996	15%	3%	3%	3%	3%	4%	4%	1%	11%	2%	3%	3%	3%	3%	2%
Jul-00	1,142	14%	2%	16%	3%	2%	3%	(4)%	8%	(1)%	0%	(1)%	(0)%	3%	1%	2%
Historic Average		45%	16%	3%	3.7%	3.2%	3.8%	10.7%	18.2%	8.0%	0.1%	1.8%	3.1%	3.4%	3.0%	3.5%

BofAML Economist Estimates		2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012	2010	2011	2012
Jan-09	357	37%	48%	NA	3.1%	3.4%	NA	17.3%	16.4%	NA	1.1%	2.0%	NA	2.4%	1.6%	NA

Source: Haver Analytics and BofA Merrill Lynch Global Research Estimates

Existing supply is the only variable that leads new home sales and sales volumes tend to lead pricing by 1-2 years

Our correlation analysis incorporated six homebuilding metrics, more than 100 housing, general economic, employment, consumer and financing variables and extended as far back as 1960 where data was available

A comprehensive look at the drivers

Our broad conclusion was that the supply of new and existing homes are the only variables that lead new home volumes (either permits or sales) and home prices tend to lag changes in volumes by 1-2 years. This relationship suggests that price growth should benefit the industry beginning in 2011 given the expected improvement in volumes throughout 2010.

We have created a matrix to capture the most significant relationships among all of the housing, economic, employment, consumer and financing metrics that were evaluated. Our analysis started with six homebuilding metrics that we wanted to identify meaningful relationships for, which included price, volume and stock performance. The price measures were new single family home median sales prices and the S&P / Case Shiller National Index. The volume metrics were housing permits and new single family home sales. We elected to use permits rather than starts given that the two measures are highly correlated and because permits are issued before home construction begins. Our analysis of stock performance was done on both an equal and market value weighted basis. The correlation work extended back to 1960 to the extent the data was available.

Following are more specific conclusions as outlined in the matrix:

New and existing home supply lead new home sales by as much as 16 months while the homeownership rate had predictive value for sales volume with a one year lag

Pricing for new and existing homes are coincident while homeownership but not vacancy rates have had an impact on price historically

New and existing home sales have been a leading indicator for the stocks while price has been a lagging indicator

The number of homes sold lead GDP by two quarters and inflation measures by one year while home prices move in a more coincident fashion with GDP and inflation trends

Employment and income measures seem to have more predictive value for home prices than sales volumes

Housing Variables

In terms of volume drivers, the supply of new one family houses led permits by three months while the supply of existing one family houses led permits by over a year. This difference makes sense as the stockpile of existing homes takes longer to work down given the size of the installed base (existing homes historically accounted for 83% of total home sales and more than 90% over the past year). The homeownership rate was correlated with both permits and sales with a one year lag, although we did not identify any relationship between volumes and vacancy rates for either homes or rental properties.

We found that pricing for new homes is tied to existing homes on a coincident basis as consumers benchmark these measures against each other to make purchase decisions. The supply of new homes leads new home pricing by as much as two years while the lead time for existing homes' supply has only been 12 months. The homeownership rate has had a coincident relationship with new house pricing, although vacancy rates were generally not important. Our sense is that homeownership rates may be a better gauge of demand (which drives pricing) while vacancy rates are more reflective of supply, which has more of an indirect impact on price depending on regional factors. We did not find a correlation between housing affordability and either home prices or volumes.

In terms of stock correlations, we found that new and existing home sales lead stock movements by up to 9 months. The homeownership rate appears to have a coincident relationship with stock prices (albeit on a quarterly basis). Prices for new and existing homes typically lag changes in the stocks by six months, which makes sense given that volumes tend to lead home prices by 1-2 years.

Economic Variables

Permits and home sales lead changes in GDP by two quarters on average and lead CPI by 12 months. Interestingly, the index of leading economic indicators has actually lagged housing volumes by a year historically. GDP, inflation measures and the index of leading indicators all have a coincident relationship with home prices. The only economic measures that appeared to be tied to homebuilding stocks were the producer price index and leading indicators, which lagged by anywhere from a few months to a year.

Employment Variables

All employment measures lagged housing volumes by 12-24 months, which included payroll growth, personal income and the savings rate (the latter being inversely correlated). In contrast, employment measures were tied to house prices on more of a real time basis. We generally found that employment metrics were more tightly correlated with home prices than permits or sales, which suggests to us that prospective buyers generally decide to buy a house due to a number of factors but that income levels have more of a direct correlation with what buyers are willing to pay. Stock prices did not show a close relationship with employment measures other than personal income.

Home sales volumes appeared to have the tightest relationship with consumer data relative to all other groups of variables and volumes generally led consumer figures by 3-12 months

The relationship between interest rates and home sales was not as strong as that of economic, employment and consumer metrics, which suggests that cost of capital is not the primary catalyst for home purchases

The stocks appear to trade tightly with homebuilders' reported orders and deliveries while revenues are more of a lagging factor

Consumer Variables

Consumer metrics had the tightest relationship with volumes amongst all of the variables that we evaluated and the lag was typically 3-12 months. The only exception was lightweight vehicle sales, which has exhibited more of a coincident relationship. Most consumer metrics have trended with home prices on a real time basis and lagged stock price movements by nine months. We did not identify any meaningful relationship between the consumer confidence index and either housing volumes or prices, which suggests to us that investors should focus on actual consumer spending trends rather than consumers' sentiment.

Financing Variables

Interest rates generally appear to be inversely correlated with both housing volume and prices, although the strength of those relationships is more modest relative to economic, employment and consumer data. This dynamic suggests that the cost of capital for a homebuyer is less important than employment or confidence (reflected in retail spending) in driving purchase decisions. Mortgage applications tend to lead pricing and trail movements in volumes while foreclosures have some impact on pricing but no identifiable impact on volumes. We recognize that historic correlations may not be the best proxy for the potential impact of foreclosures given the unprecedented levels faced currently. The only financing metric that influences stock prices appears to be mortgage applications.

Homebuilding Company Variables

Orders, homes delivered and revenues all appear to have strong relationships with industry pricing metrics with anywhere from a two quarter (revenues) to five quarter (orders) lead time. The relationship with industry volumes is not as close but new home sales have exhibited some predictive power for company revenues and deliveries with a 2-3 quarter lead time. The stocks appear to trade off of orders and deliveries on a real time basis while revenues have more of a lagging impact. This lag makes sense given our view that pricing trails behind volumes in the homebuilding industry.

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Table 16: Correlation Matrix for Homebuilding Price, Volume and Stock Performance Metrics

	PRICE METRICS		VOLUME METRICS		STOCK PERFORMANCE	
	New 1 Family Home Median Sales Price	S&P / Case Shiller National Price Index	Housing Permits for 1 Unit Structures	New 1 Family Home Sales	Equal Weighted Industry Index	Market Cap Weighted Industry Index
HOUSING DATA						
Monthly Availability						
New 1 Family Home Median Sales Price			(24)	(24)	(6)	(6)
Existing 1 Family Home Median Sales Price			(12)		(6)	(6)
S&P / Case Shiller National Price Index			(18)	(24)	(6)	(6)
Housing Permits for 1 Unit Structures	24	18				
New 1 Family Home Sales	24	24			9	9
Existing 1 Family Home Sales	13	13				
New 1 Family Homes Months Supply			3			
Existing Home Months Supply at Current Sales Rate			16			
Private Residential Construction (1)						
Total Number of Break-Adjusted Households			(12)			
Total Resident Population						
Quarterly Availability						
Residential Properties (Improvement and Repairs) (1)						
Homeownership Rate (1)			(4)	(4)		
Rental Vacancy Rate						
ECONOMIC DATA						
Monthly Availability						
CPI (All Items)			(12)			
PPI (Finished Goods Including Foods and Fuel)					(14)	(14)
Composite Index of 10 Leading Indicators				(12)	(2)	(2)
Merchant Wholesalers' Total Sales						
Quarterly Availability						
Gross Domestic Product (1)			(2)	(2)		
Real Gross Domestic Product (1)			(2)	(2)		
EMPLOYMENT DATA						
Monthly Availability						
ADP Nonfarm Private Payroll Employment			(21)	(21)		
Total Nonfarm Employment			(12)	(12)		
Personal Income (1)			(12)	(12)	(12)	(12)
Personal Saving Rate (1)	(*)	(*)	(12) (*)	(12) (*)		
CONSUMER DATA						
Monthly Availability						
Consumer Credit Outstanding			(3)	(12)	(9)	(5)
Personal Consumption Expenditures (1)			(12)	(12)	(9)	(9)
Light Weight Vehicle Sales (1)						
Total Retail Sales			(12)	(12)	(9)	(9)
FINANCING DATA						
Monthly Availability						
MBA Volume Index (Mortgage Loan Applications for Purchase)	11	11	(6)	(6)		
Home Mortgage Loans (Contract Interest Rate for All Loans Closed)		12 (*)	(*)	(*)		
30-Year Treasury Bond Yield at Constant Maturity	(*)	(*)	(*)	(*)		
Quarterly Availability						
Mortgage Foreclosure Inventory	6					
Mortgage Originations for 1-4 Families (Purchases)	2	2				
HOMEBUILDER COMPANY DATA						
Quarterly Availability						
Revenues	2	2	(2)	(3)	(3)	(3)
Homes Delivered	3	3	(2)	(2)		
Net Orders	5	5				

Dark blue shading indicates that a very strong relationship exists between the 2 variables (correlation coefficient > = 0.9)

Light grey shading indicates that a moderately strong relationship exists between the 2 variables (correlation coefficient > 0.5 and < 0.9)

No shading indicates that no identifiable relationship exists between the 2 variables

Cells with a numerical value > 0 indicate the number of months / quarters that the variable in the first column leads the price, volume or stock performance metrics

Cells with a numerical value < 0 indicate the number of months / quarters that the variable in the first column lags the price, volume or stock performance metrics

Cells that have dark blue or light grey shading but no numerical value indicate a coincident relationship between the variable in the first column and the price, volume or stock performance metrics

(*) Indicates that an inverse correlation exists as all other correlations were found to be positive

(1) Annualized rate

All data is seasonally adjusted where available

Source: BofA Merrill Lynch Global Research Estimates

Where the headline housing metrics stand

We think a number of housing metrics drive investor perception even though not all of the data points have shown a tight correlation with home sales

Investors tend to focus on certain housing metrics in order to gauge the health of the industry, which include some we view as predictive and others that do not show relevant correlation. Irrespective of our correlation analysis, we think tracking each of these metrics is important in the context of understanding potential headline risks (or benefits) to the stocks. We compared each metric to new single family home sales, which is the closest proxy for revenues for the homebuilders in our coverage universe.

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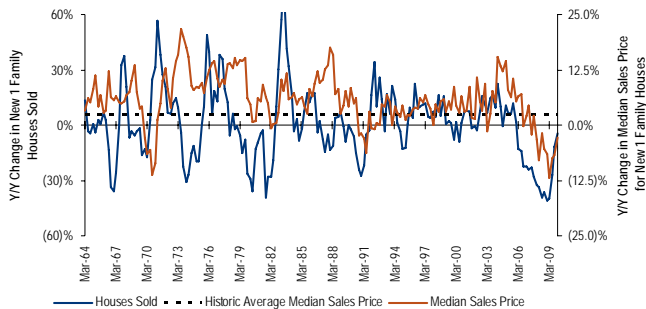
The decline in December single family home sales was likely driven by uncertainty around the tax credit extension and the sales rate for 2009 was the lowest in any 12 month period since data became available 46 years ago

The relationship between sales volume and price has been tighter during this cycle than in the past while a reversion of the homeownership rate to the historic mean would imply a half year of supply, although government programs should keep ownership rates at elevated levels

New single family homes sold declined 9% y/y and 8% q/q on a seasonally adjusted annualized basis during December 2009. December sales marked the lowest level since March 2009, which in our view can be partially attributed to uncertainty over extension of the homebuyer tax credit. The credit was originally scheduled to expire at the end of November but was extended through June 2010 as part of an announcement in early November. Home closings take a minimum of 30-60 days so the extension was unlikely to stimulate demand in the month following its announcement. New single family home sales for full year 2009 were 374k, which marked the lowest level for any 12 month period since data became available in 1963. By comparison, the average over the past 20 years has been 800k sales on an annual basis.

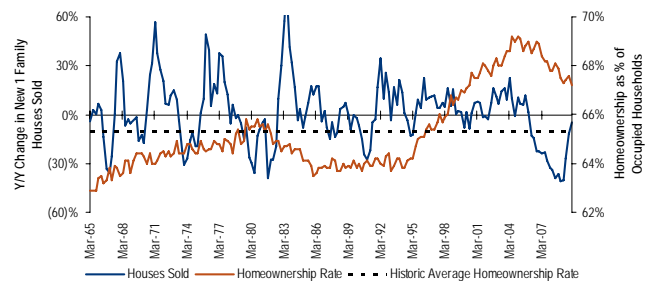
New home sales have historically led pricing by two years, although the relationship during this cycle has been more coincident as sales bottomed in January 2009 while pricing reached a trough only a few months later. Pricing was down 4% y/y during December, which is consistent with the magnitude of decline over the past four months. The 8% price increase from the lows in 2009 is still 16% below the 2007 peak and we do not expect that gap to narrow further until 2011. The latest homeownership rate in September 2009 was 67.6%, which is down from a peak of 69% but still above the historic average of 65%. Reverting to historic averages would imply an available inventory of 2.5mn homes for sale, which equates to a half year of supply versus 5mn homes sold during 2009. We do not anticipate this inventory coming to market in a fashion that would disrupt the supply and demand balance due to the government's mortgage modification program and banks' unwillingness to sell properties at depressed prices.

Chart 10: Y/Y Change in New Houses Sold versus Sales Price



Source: Haver Analytics

Chart 11: Y/Y Change in New Houses Sold versus Homeownership Rate

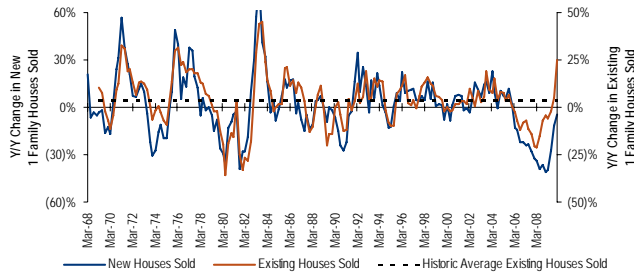


Source: Haver Analytics

New and existing home sales have typically had a coincident relationship but existing sales have far outpaced new sales during this cycle recovery while the rental vacancy does not appear to be correlated with new home sales

Existing home sales historically have had a coincident relationship with new home sales, although the improvement in recent months has not been mirrored to the same extent by the upswing in new home sales. Existing home sales increased 13% y/y in December annualized while new home sales declined 9%, which in our view is attributable to the impact of uncertainty over the homebuyers' tax credit. New homes typically require four months to build while resales of existing homes can be completed in 60 days such that existing home sales probably have benefited more from the tax credit in terms of absolute units sold. The rental vacancy rate has not exhibited much correlation with home sales and appears to be in a secular uptrend that began in the early 1980s. As a result, a reversion from 11% now to the 7.3% historic average may be unlikely.

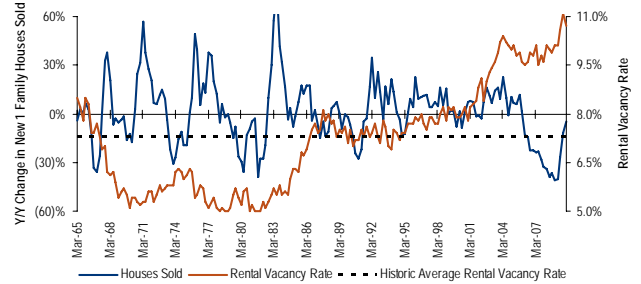
Chart 12: Y/Y Change in New Houses Sold versus Existing Houses Sold



Source: Haver Analytics

Affordability is at unprecedented levels due in part to record low interest rates, which we estimate has a 50k impact on home sales for every 100bp swing

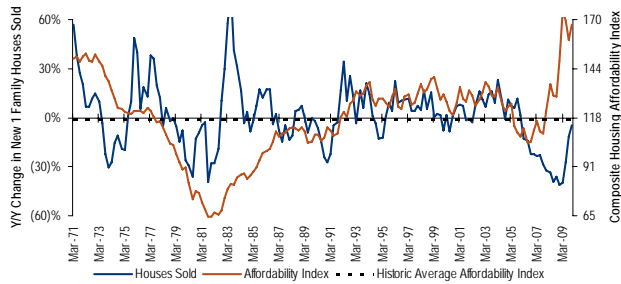
Chart 13: Y/Y Change in New Houses Sold versus Rental Vacancy Rate



Source: Haver Analytics

The affordability index has not been closely correlated with new home sales in the past but now stands at a record level of 168 versus 117 historically, which is not a surprise given the decline in home prices and record low interest rates. Average interest rates on mortgage loans were 5% as of the end of December versus 8.6% historically, which reinforces the improvement in the affordability index over the past year. We estimate that a 100bp change in interest rates has historically had a 50k impact on new homes sold, although interest rates are at unprecedented lows and therefore the historic relationship may not be as applicable now. Having said that, our analysis suggests employment is a more important factor for homebuyers than the cost of capital and therefore a pick-up in employment could be magnified if affordability remains above historic levels.

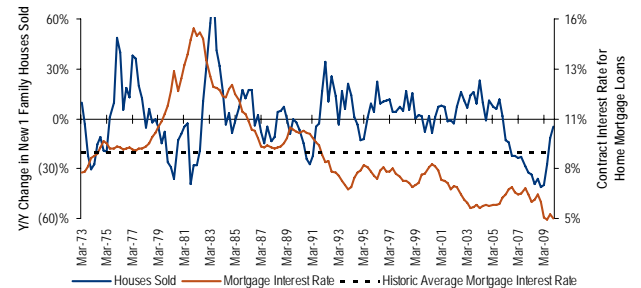
Chart 14: Y/Y Change in New Houses Sold versus Affordability Index



Source: Haver Analytics

Months supply of new homes now stands at 8.1 versus a normalized level of six but the desire of builders to have homes available for tax credit stimulated demand may explain why supply has not converged more toward the historic mean

Chart 15: Y/Y Change in New Houses Sold versus Interest Rates

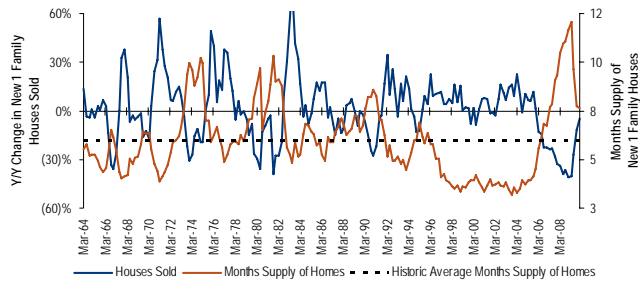


Source: Haver Analytics

Months supply of new homes have had a real time impact on new home sales while the supply of existing homes has not had as much influence based on our correlation analysis. New home supply stands at 8.1 months as of December, which is down from a peak of 12 months in early 2009 but still above the six month historic average. Supply inched up by half a month from November levels, although we think builders may intentionally be building speculative inventory in anticipation of tax credit stimulated demand in the upcoming selling season. The supply of existing homes is now seven months, which is in line with the historic average and down from a peak of 11 months in mid-2008. Although existing home supply has not had a direct influence on new home sales in the past, we think a normalized supply of existing homes enhances the likelihood that new home sales growth remains healthy beyond the expiration of the tax credit.

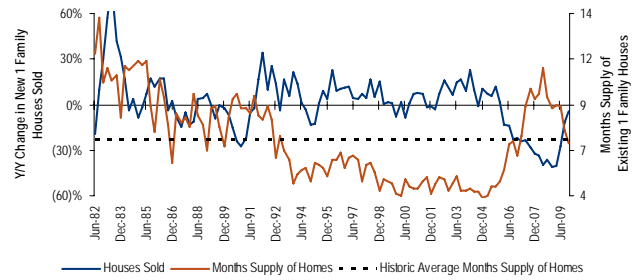
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Chart 16: Y/Y Change in New Houses Sold versus Months Supply of New Homes



Source: Haver Analytics

Chart 17: Y/Y Change in New Houses Sold versus Months Supply of Existing Homes



Source: Haver Analytics

Learning from history Starts are showing a familiar pattern

The decline in starts during this cycle and the subsequent recovery has mirrored the duration of past declines and recoveries thus far

Despite concerns that the housing market faces unprecedented challenges, the length of the downturn and subsequent rate of improvement have been comparable to past cycles. Starts declined 80% from the peak in January 2006 to a trough 36 months later, which was nearly double the historic decline of 44% but consistent in terms of duration (32 months). Starts typically require 10 months to return to the prior three year average and that increase has averaged 38%, which is mirrored by the 11 month recovery and 28% increase in starts as of December 2009. Our analysis suggests that a return to the next peak typically takes three years and results in a doubling of starts off of the bottom. Applying the same parameters to the current cycle would imply a 700k single family and 870k total start run rate at the beginning of 2012, which is still below our estimates of a normalized level but would mean a 24% increase in each of the next two years.

Table 17: Historic Peaks and Troughs for Single Family Housing Starts

Peak		Trough				Return to 3 Year Average				Next Peak			
Month	Starts	Month	Starts	Length of Downturn (Number of Months)	% Decline from Peak	Month	Starts	Length of Upturn (Number of Months)	% Increase from Trough	Month	Starts	Length of Upturn (Number of Months)	% Increase from Trough
Feb-64	1,162	Oct-66	597	32	(49)%	Jul-67	875	9	47%	Feb-68	993	16	66%
Feb-68	993	Jan-70	596	23	(40)%	Sep-70	865	8	45%	Jan-73	1,431	36	140%
Jan-73	1,431	Feb-75	667	25	(53)%	Oct-75	1,039	8	56%	Dec-77	1,530	34	129%
Dec-77	1,530	Oct-81	523	46	(66)%	Nov-82	865	13	65%	Feb-84	1,400	28	168%
Feb-84	1,400	Jan-91	604	83	(57)%	Dec-91	947	11	57%	Dec-93	1,316	35	118%
Dec-93	1,316	Mar-95	996	15	(24)%	Jun-95	1,022	4	3%	Dec-98	1,412	45	42%
Dec-98	1,412	Jul-00	1,142	19	(19)%	Dec-00	1,226	6	7%	Jan-06	1,823	66	60%
Average	1,332		746	32	(44)%		987	10	38%		1,383	37	95%
Jan-06	1,823	Jan-09	357	36	(80)%	Dec-09	456	11	28%		?	?	?

Source: Census Bureau and BofA Merrill Lynch Global Research Estimates

Real pricing has declined 25% during the most recent cycle versus 18% during past downturns but has already exhibited some improvement off of trough levels

The average decline in real prices (inflation adjusted) for new homes was 18% over an average of 35 months during past cycles, which basically matches the duration of the decline in housing starts. The most recent cycle was more severe with prices declining 25% in real terms over 41 months, which is not a surprise given that foreclosure rates are at unprecedented levels. The subsequent pricing recovery typically is 40% but duration has varied widely from as few as 31 months (1970-1973) to as long as 14 years (1992-2006). Pricing during the current cycle bottomed in August and has increased 6% in real terms since that point, although we do not expect price growth to be a meaningful operating leverage catalyst for the builders until 2011.

Table 18: Historic Peaks and Troughs for Single Family New Home Median Sales Prices (Adjusted for Inflation)

Peak		Trough				Next Peak			
Month	Price	Month	Price	Length of Downturn (Number of Months)	% Decline from Peak	Month	Price	Length of Upturn (Number of Months)	% Increase from Trough
Jul-73	\$23,519	Aug-75	\$21,343	24	(9)%	Jun-79	\$27,015	46	27%
Jun-79	\$27,015	Sep-82	\$20,975	39	(22)%	Jan-88	\$30,791	64	47%
Jan-88	\$30,791	May-92	\$24,225	52	(21)%	Apr-06	\$38,132	167	57%
Average	\$25,573		\$20,892	35	(18)%		\$29,864	77	42%
Apr-06	\$38,132	Aug-09	\$28,488	41	(25)%	Dec-09	\$30,139	4	6%

Source: Census Bureau and BofA Merrill Lynch Global Research Estimates

Starts have been 1.5mn historically but we think the “new normal” will be 1.2mn based on a set of reasonable assumptions for population growth and housing units

Gauging the “new normal” for starts

Housing starts have averaged 1.5mn units per year over the past 50 years while single family starts have typically tracked at 1.1mn, which implies that single family units have accounted for 72% of total starts. Looking more closely at recent history, the total number of annual starts over the past 20 years has remained steady at 1.5mn while single family starts approached 1.2mn (80% of total starts). Our analysis suggests that the “new normal” for housing starts over the life of a cycle could be 1.2mn with 900k being single family residences. By comparison, the BofA Merrill Lynch economics team is modeling 1.125mn starts in 2011 so the normalized trajectory may not be reached until 2012 at the earliest.

Table 19: Scenario Analysis of “New Normal” for Housing Starts

Population Growth	Owner-Occupied Housing Unit Growth as % of Population Growth					
	15%	20%	25%	30%	35%	40%
1.1%	669	892	1,115	1,338	1,561	1,784
	492	656	820	984	1,149	1,313
1.0%	608	811	1,013	1,216	1,419	1,621
	447	597	746	895	1,044	1,193
0.9%	547	730	912	1,094	1,277	1,459
	403	537	671	805	940	1,074
0.7%	426	567	709	851	993	1,135
	313	418	522	626	731	835
0.5%	304	405	507	608	709	811
	224	298	373	447	522	597

We think annual expansion of 1.2mn total housing starts and 900k single family housing starts may represent the “new normal” assuming that population growth continues to track around 1% and owner-occupied housing unit growth relative to population expansion returns to halfway between 2009 and historic levels

Each cell includes expected annual housing starts and 1 family housing starts based on the following assumptions:
(1) different population growth scenarios
(2) different owner-occupied housing growth scenarios
(3) housing starts and single family housing starts as % of owner-occupied housing growth return to the midpoint between 2009 levels and the 1965-2009 average

Source: Haver Analytics and BofA Merrill Lynch Global Research Estimates

Our analysis assumes population growth slightly below the historic average while growth in total housing units and starts relative to housing units should remain below the mean since 1965

Our analysis assumes that population growth will be 1%, which is slightly below the 1.1% historic average. The growth in owner-occupied housing units as a % of population growth declined to 24% in 2009 versus 40% since 1965 and we think that growth rate can return to 30% under normal conditions as excess housing supply is fully worked through. Historically, housing starts have represented 176% of owner-occupied housing unit growth, although that rate declined to 88% in 2009 and our analysis assumes that only half of the decline is recaptured over time. The same methodology has been applied to single family starts as we expect only half the difference between historic starts versus housing unit growth (125%) and current levels (69%) to be made up over time.

Table 20: Historical Population and Housing Growth Rates

	1965-2009	1989-2009	2009	2009 versus Historic Averages	
				1965-2009	1989-2009
Population Growth	1.1%	1.1%	0.9%	(0.2)%	(0.2)%
Owner-Occupied Housing Units as % of Population	23.2%	24.8%	24.5%	1.3%	(0.2)%
Owner-Occupied Housing Unit Growth as % of Population Growth	39.5%	34.0%	24.1%	(15.4)%	(9.9)%
Total Housing Starts as % of Owner-Occupied Housing Unit Growth	175.9%	167.3%	88.2%	(87.7)%	(79.1)%
1 Family Housing Starts as % of Owner-Occupied Housing Unit Growth	125.3%	134.6%	69.1%	(56.2)%	(65.5)%

Source: Haver Analytics and BofA Merrill Lynch Global Research Estimates

A more tepid stock recovery than usual

The performance of homebuilding stocks coming out of the current downturn suggests that the market is more cautious on the pace of industry recovery relative to the overall economy as compared to past cycles. This doubt is one of the reasons that we are anticipating appreciation for most of the stocks over the

next year against the backdrop of volume improvement. Homebuilding stocks historically have bottomed out three months before the trough in starts, although the bottom was more coincident in the current cycle. The stocks typically appreciate 100% in the first year of recovery followed by 20% and 41% upside in years two and three, respectively.

The homebuilding stocks have not outperformed the market coming out of this downturn to the same extent as past cycles, which reflects doubt regarding the sustainability of the recovery

The relative performance versus the market underscores the early cycle nature of the homebuilders as the stocks typically outpace the S&P 500 by 90 percentage points in the first year of recovery followed by more modest outperformance in years two and three. By comparison, homebuilding stocks have outperformed by 65 percentage points since the bottom in early 2009, which is second lowest as compared to the four previous cycle troughs since the early 1980s.

Table 21: Historic Performance of Homebuilding Stocks and S&P 500 versus Troughs in Housing Starts

Trough In Starts	Trough in Index		Trough in Index Months (Before) / After Trough in Starts		% Change in Homebuilders Index Following Trough in Starts			% Change in S&P 500 Following Trough in Starts			Homebuilders Index versus S&P 500 (basis points)		
	Homebuilders	S&P 500	Homebuilders	S&P 500	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3
Oct-81	Oct-81	Sep-81	0	(1)	98%	58%	(7)%	10%	22%	2%	8,822	3,600	(868)
Jan-91	Oct-90	Oct-90	(3)	(3)	133%	(8)%	20%	19%	7%	10%	11,438	(1,494)	1,063
Mar-95	Nov-94	Jun-94	(4)	(9)	37%	6%	113%	29%	17%	46%	770	(1,129)	6,707
Jul-00	Jan-00	Sep-02	(6)	26	147%	25%	38%	(15)%	(25)%	9%	16,196	4,984	2,903
Average			(3)	3	104%	20%	41%	11%	6%	16%	9,306	1,490	2,451
Jan-09	Feb-09	Feb-09	1	1	95%			30%			6,544		

Housing Starts only pertain to 1 family units

Source: Factset and BofA Merrill Lynch Global Research Estimates

The severity of the decline since 2006 is underscored by the three consecutive years of stock price compression faced by the homebuilders, which compares to typically one year of downside in past cycles. The underperformance versus the market is also unprecedented, which is not a surprise given doubts about whether current challenges will prove to be secular or cyclical.

Table 22: Historic Performance of Homebuilding Stocks and S&P 500 versus Peaks in Housing Starts

Peak In Starts	Peak in Index		Peak in Index Months (Before) / After Peak in Starts		% Change in Homebuilders Index Following Peak in Starts			% Change in S&P 500 Following Peak in Starts			Homebuilders Index versus S&P 500 (basis points)		
	Homebuilders	S&P 500	Homebuilders	S&P 500	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3
Feb-84	May-83	Jun-83	(9)	(8)	23%	42%	62%	15%	25%	25%	787	1,667	3,628
Dec-93	Jan-94	Jan-94	1	1	(36)%	53%	8%	(2)%	34%	20%	(3,489)	1,931	(1,264)
Dec-98	Jun-98	Jul-98	(6)	(5)	(22)%	108%	51%	20%	(10)%	(13)%	(4,130)	11,857	6,363
Jan-06	Jul-05	Oct-07	(6)	21	(21)%	(53)%	(55)%	12%	(4)%	(40)%	(3,294)	(4,907)	(1,534)
Average			(5)	2	(14)%	38%	16%	11%	11%	(2)%	(2,531)	2,637	1,798

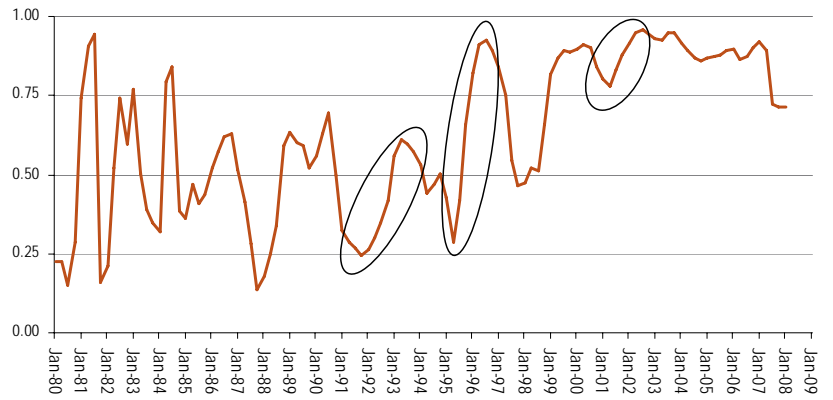
Housing Starts only pertain to one family units

Source: Factset and BofA Merrill Lynch Global Research Estimates

Homebuilding stocks tend to show tighter correlation in the two years following a cycle trough, which justifies our cluster of Buy ratings

Our analysis suggests that homebuilding stocks have become more closely correlated since the early 1990s as the correlation coefficient for the industry has increased from 0.25 to 0.75 currently. This convergence does not come as a surprise given that the public builders have become larger relative to the total industry and therefore each company has become a closer proxy for the performance of the overall market. What is more interesting is the spike in correlation that typically takes place in the two years after the bottom in housing starts. The past three troughs (January 1991, March 1995, July 2000) have each resulted in a significant increase in the correlation coefficient and therefore we think a high concentration of Buy ratings makes sense at this point in the cycle. We think investment selection becomes more company specific as a cycle matures given that correlations tend to weaken as the stocks discount the next leg of the cycle.

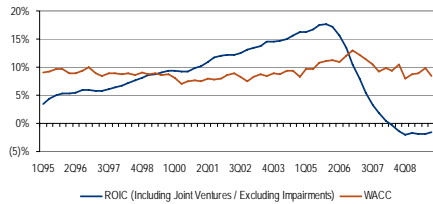
Chart 18: Two Year Rolling Correlation Coefficients for Homebuilding Stocks



Source: Factset and BofA Merrill Lynch Global Research Estimates

The economics of homebuilding Balancing margins and velocity

Chart 19: Industry ROIC versus WACC



Source: Company Reports and BofA Merrill Lynch Global Research Estimates

ROIC is unlikely to exceed capital costs over a full cycle but our analysis suggests that 20-30% rates of return can currently be achieved on new communities geared toward first-time homebuyers

ROIC for the homebuilding industry has averaged 8.7% since 1995 but has only exceeded the cost of capital during 1999-2006. By comparison, cost of capital (WACC) has consistently tracked at ~9% for the past 15 years. Homebuilders have achieved some sustained production efficiencies and are generally focused on limiting land supply (asset light model), although cyclical forces are too intense to ensure returns remain above capital costs throughout a cycle in our opinion. We are currently modeling ROIC to turn positive for the industry in 2011 as new projects are carrying returns that are well above the average level of (1.6)% currently, which is being weighed down by legacy land purchase decisions.

Many homebuilders target unlevered internal rates of return (IRR) of 20-30% for projects assuming gross margins in a similar range, which is achievable in our opinion. IRR is driven by margins and sales pace and our analysis suggests that eight homes must be sold per quarter in the average community in order to achieve above 20% IRRs (assuming 20%+ margins). We estimate 100bp of gross margin improvement or the sale of one additional home per community per quarter can yield a 150bp boost to IRR. Given that volumes tend to lead price coming out of downturns, we think a continued focus on first-time communities makes sense as these typically carry a faster sales pace at modestly lower margins. In contrast, active adult and luxury communities require higher margins to compensate for slower asset turnover and the expected lack of price gains over the next year imply that targeted margins will be difficult to achieve for these buyer profiles.

Table 23: Scenario Analysis for Internal Rate of Return Based on Sales Velocity and Margin

Gross Margin	Sales Velocity (Homes Delivered per Quarter)					
	4	6	8	10	12	14
15%	3%	4%	5%	6%	7%	7%
20%	8%	11%	14%	16%	19%	21%
25%	13%	19%	24%	28%	32%	35%
30%	19%	27%	34%	40%	47%	51%
35%	25%	36%	46%	54%	63%	70%
40%	32%	46%	59%	70%	82%	91%

Each cell represents an internal rate of return for a community assuming:
 (1) 100 lots in the community
 (2) sale price of \$250k per home
 (3) Land acquisition and development accounts for 33% of construction costs
 (4) SG&A expense is 12% of sales price

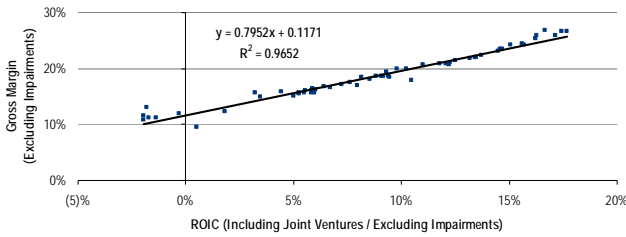
We think a normalized internal rate of return of 15-25% can be achieved with a quarterly sales velocity of 6-8 homes and gross margins of 20-25%

Source: BofA Merrill Lynch Global Research Estimates

ROIC has been more tightly correlated with gross margins than land supply but we think striking a balance between margins and sales velocity is important

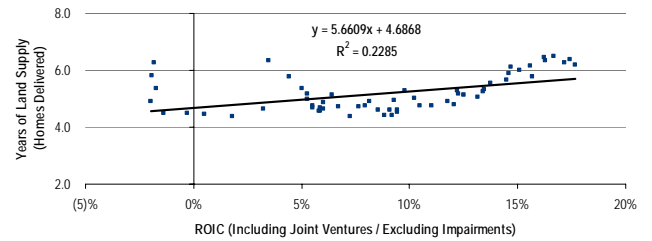
Our analysis has found a much closer relationship between ROIC and gross margins than ROIC and land supply (a proxy for sales velocity) since 1995, although striking a balance between margins and sales pace still makes strategic sense. This view is predicated on the most recent downturn and the challenges faced by companies that bought land carrying a long term time horizon but an attractive margin profile at the time.

Chart 20: Gross Margins versus ROIC for 1995 - 2009



Source: Company Reports and BofA Merrill Lynch Global Research Estimates

Chart 21: Years of Land Supply versus ROIC for 1995 - 2009



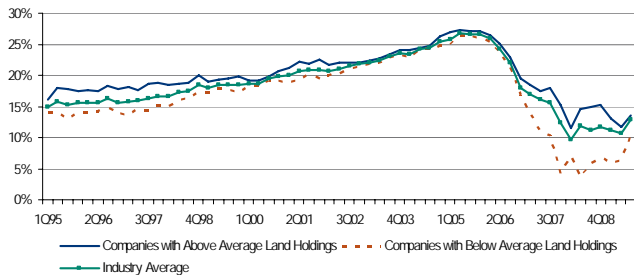
Source: Company Reports and BofA Merrill Lynch Global Research Estimates

Gross margins have typically been higher for companies with more land supply but SG&A expense has surprisingly been comparable for asset light and heavy companies

Why an asset light model makes more sense

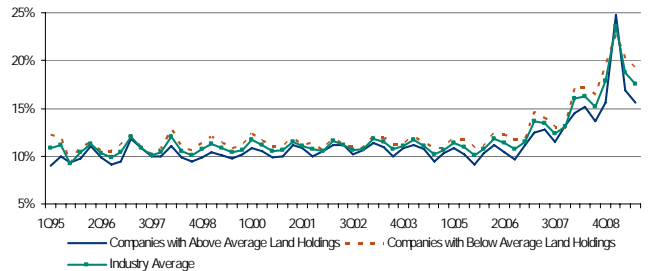
Many homebuilders have embraced an asset light model on the premise that carrying less land supply makes sense as long as the appropriate balance can still be struck between margins and sales velocity. We agree with this view in principal but think some areas of the country where permitting is more onerous do require larger land holdings. Companies with more years of land supply have historically carried higher gross margins (excluding impairments), which does not come as a surprise given that profitability should offset lower asset turnover. SG&A expense as a % of revenues has actually been comparable for companies with above and below average land supply, which contrasts with our view that SG&A expense should be higher for companies with lower years of land supply given the need to prospect for new lots more regularly.

Chart 22: Gross Margin (Excluding Impairments) for Companies with Different Land Holdings



Companies with Above Average Land Holdings include DHI, LEN, PHM and TOL
Companies with Below Average Land Holdings include BZH, HOV, KBH, MDC and RYL
Source: Company Reports and BofA Merrill Lynch Global Research Estimates

Chart 23: SG&A Expense as % of Revenue for Companies with Different Land Holdings

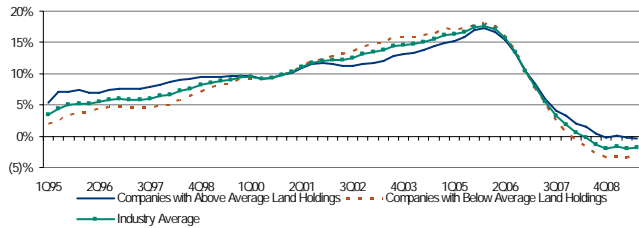


Companies with Above Average Land Holdings include DHI, LEN, PHM and TOL
Companies with Below Average Land Holdings include BZH, HOV, KBH, MDC and RYL
Source: Company Reports and BofA Merrill Lynch Global Research Estimates

Companies with more land tend to generate a higher ROIC in the early phases of industry recoveries but we do not think those returns adequately compensate for the risks inherent in that business model

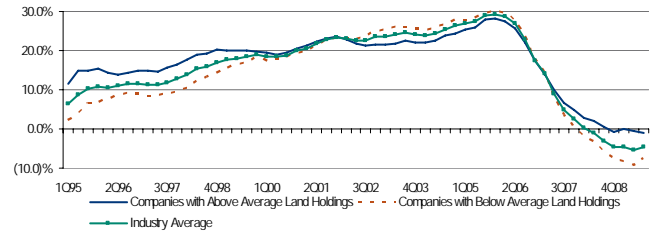
ROIC and ROE (excluding impairments) have exhibited varying trends as companies with above average land holdings achieved higher returns coming out of the last major downturn in the early 1990s and are generating similar upside to land light companies now. In contrast, companies with less land inventory generated the highest returns between 2000 and the cycle peak, which is a surprise given that companies with more land holdings should theoretically be able to achieve better leverage around market peaks. Despite the higher returns currently being achieved by companies with more land, we do not think the spread over asset light companies is adequate to compensate for the risk that comes with owning more land. We therefore believe that an asset light model makes more sense to operate under for the full duration of a cycle.

Chart 24: ROIC for Companies with Different Land Holdings



Companies with Above Average Land Holdings include DHI, LEN, PHM and TOL
Companies with Below Average Land Holdings include BZH, HOV, KBH, MDC and RYL
ROIC includes the contribution from joint ventures where applicable but excludes all impairments
Source: Company Reports and BofA Merrill Lynch Global Research Estimates

Chart 25: ROE for Companies with Different Land Holdings

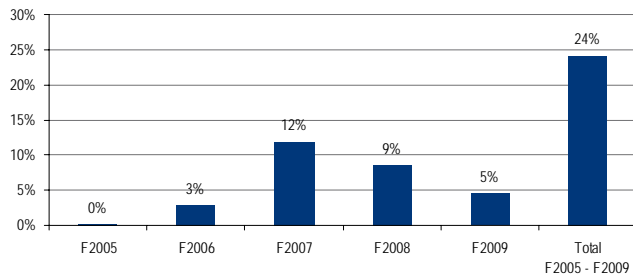


Companies with Above Average Land Holdings include DHI, LEN, PHM and TOL
Companies with Below Average Land Holdings include BZH, HOV, KBH, MDC and RYL
ROE includes the contribution from joint ventures where applicable but excludes all impairments
Source: Company Reports and BofA Merrill Lynch Global Research Estimates

The industry has impaired 24% of its asset base since 2005 but BZH, DHI, PHM and TOL face the most risk of additional impairments through the middle of 2011

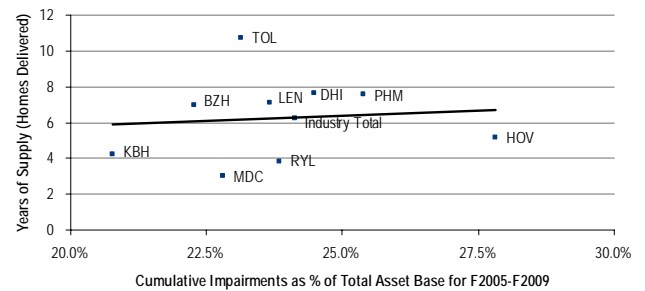
We think companies with above average land holdings continue to face a risk of future impairments given that impairments already recognized as a % of their asset bases (defined as inventory, joint venture investments and intangible assets) are in line with the industry average of 24% between 2005 and 2009. We think BZH, LEN, DHI, PHM and TOL are particularly at risk given their above average land holdings relative to the magnitude of past impairments. We are modeling impairments to remain an earnings drag through the middle of 2011, which should coincide with when pricing begins to improve across the industry.

Chart 26: Impairments as % of Industry Asset Base



Source: Company Reports and BofA Merrill Lynch Global Research Estimates

Chart 27: Cumulative Impairments versus Years of Supply



Source: Company Reports and BofA Merrill Lynch Global Research Estimates

Table 24: Speculative Units as % of Current Backlog
Historic (1995 - 2009)

Company	Most Recent	Average		
	Quarter	Maximum	Minimum	
DHI	176%	100%	155%	71%
LEN	169%	129%	268%	71%
BZH	97%	54%	114%	4%
Industry Average	73%	40%	104%	7%
MDC	65%	56%	154%	16%
PHM	47%	26%	74%	0%
HOV	37%	33%	69%	13%
RYL	25%	23%	41%	10%
TOL	24%	21%	31%	12%
KBH	13%	18%	32%	9%

Source: Company Reports and BofA Merrill Lynch Global Research Estimates

As part of an asset light model, utilizing speculative units make sense in terms of enhancing sales velocity in our opinion. This approach should prove particularly beneficial during the first half of 2010 to the extent that the existing federal tax credit stimulates additional demand for purchases prior to June 30. Speculative homes can typically be closed on in 30-60 days versus 4-6 months for pre-sold units, which suggests that speculative units will be the only viable means of taking advantage of the tax credit beyond March. Constructing speculative homes clearly poses a risk given demand uncertainty, although we think the use of speculative units to boost volumes coming out of a cyclical downturn makes sense given that volume growth leads pricing in the housing market. DHI historically has embraced the speculative strategy most aggressively (equivalent to 176% of backlog). The industry carries speculative units that equate to 73% of total backlog, which is well above historic averages due to anticipation of sales activity tied to the tax credit over the next few quarters.

Table 25: Years of Land Supply (Homes Delivered)

Company	Historic (1995 - 2009)			
	Most Recent Quarter	Average	Maximum	Minimum
TOL	10.8	8.9	11.7	7.1
BZH	7.9	4.4	7.0	2.5
LEN	7.9	5.8	9.9	2.6
PHM	7.5	7.3	11.0	4.2
DHI	6.8	5.0	7.6	2.1
Industry Average	6.4	5.2	6.5	4.4
HOV	5.2	4.5	9.0	1.7
KBH	4.3	4.0	7.1	2.7
RYL	3.9	3.8	5.4	2.7
MDC	3.0	2.7	4.8	1.8

Years of Land Supply does not include lots available through joint ventures
Source: Company Reports

Homebuilders have historically carried 5.2 years of land supply versus a 3-4 year optimal target and we anticipate companies with significant land holdings will continue to purchase lots that are more conducive to a quick turn strategy

The profile of current land holdings

Homebuilders have historically carried 5.2 years of land supply through lots that are directly owned and under option agreements. Current supply stands at 6.4 years based on trailing 12 month deliveries, although we expect supply to converge toward the historic average over the next few years as sales growth picks up. By comparison, we think 3-4 years of land supply is optimal given that building cycles have typically lasted six years with the upswing and downswing periods being equally split (each part lasting three years on average).

TOL and PHM have historically carried the most land supply, which is partially a function of their presence in the active adult segment where community sell through tends to be longer. On the other end of the spectrum are MDC and RYL, which have always embraced the asset light model. All companies other than TOL have at least partially moved toward an asset light strategy, although we think the legacy land holdings of many companies are not conducive to quicker sales because of their location. We therefore expect companies with above average land holdings to still pursue lot purchases in areas that are geared toward quicker asset turns (e.g. accessibility to job centers and shopping).

Spending for homebuilders will increasingly be geared toward finished lot purchases rather than land requiring development, which is a longer duration asset (inconsistent with asset light model). Those companies with a higher mix of finished lots or homes under construction will face somewhat less pressure to purchase already finished lots while those below the 43% industry average may need to spend more aggressively irrespective of existing years of land supply.

Table 26: % of Land Holdings by Category Based on Dollars Invested

Company	Finished Lots / Homes Under Construction	Land Under Development / Not Developed	Land Held for Sale	Consolidated Inventory Not Owned	Land Under Option Agreements	Total
TOL	64%	23%	0%	0%	14%	100%
KBH	57%	21%	0%	0%	22%	100%
BZH	52%	27%	3%	4%	14%	100%
Industry Average	43%	36%	1%	3%	16%	100%
HOV	43%	25%	0%	7%	25%	100%
RYL	38%	30%	7%	0%	26%	100%
MDC	37%	37%	0%	0%	25%	100%
LEN	37%	49%	0%	15%	0%	100%
DHI	34%	53%	0%	0%	13%	100%
PHM	29%	56%	1%	3%	10%	100%

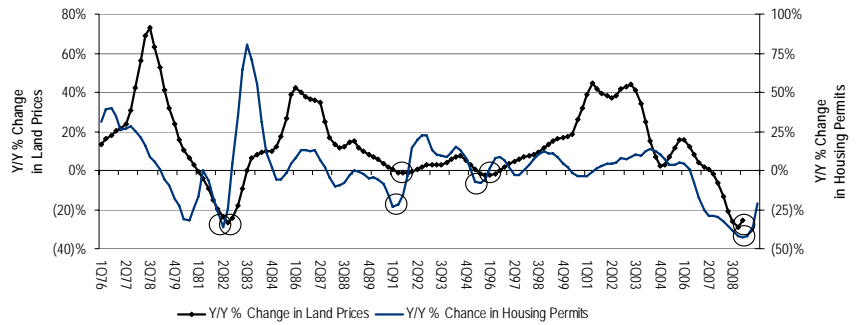
Source: Company Reports

Land prices have typically reached a trough 2-4 quarters after housing permits and therefore we expect bidding on land to intensify at some point during 2010

Understanding the lag in land prices

Our analysis suggests that land prices typically trough 2-4 quarters after the low point for construction permits during a cycle. This relationship suggests that land prices will begin to appreciate during the first half of 2010 as permits bottomed in January 2009. We believe that some desirable locations are already facing bidding pressure for finished lots that are more conducive to an asset light strategy. Most builders are committed to finished lot transactions for now, although we expect purchases requiring some development work to become more common once competitive dynamics intensify. This shift would stretch out asset turnover rates, although price appreciation would presumably make up for that drag in the form of higher margins.

Chart 28: Y/Y Change in Land Prices and Housing Permits



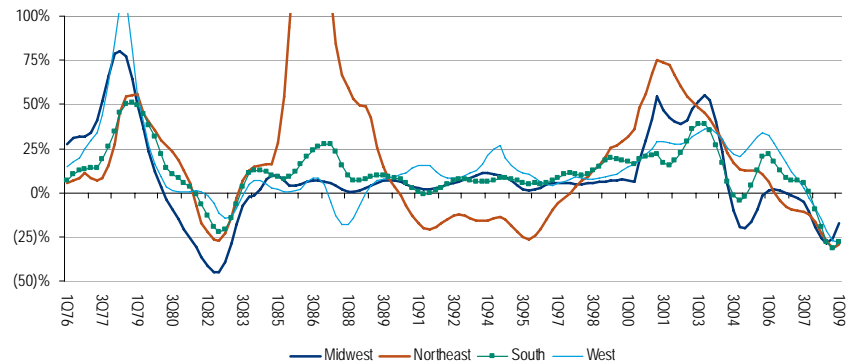
Circles denote trough during each cycle for land prices and housing permits

Source: Lincoln Institute of Land Policy, Graaskamp Center at the Wisconsin School of Business, Haver Analytics and BofA Merrill Lynch Global Research Estimates

Land prices have historically been most volatile in the Northeast and West but the nature of those markets require more land inventory in order to compete

The Northeast and West have historically exhibited the most land price volatility while other regions have been more stable. This dynamic suggests that holding less land in those regions makes strategic sense given that longer duration communities carry greater uncertainty. Having said that, the permitting process tends to be more challenging in those parts of the country (particularly California and the New York metropolitan area) and therefore builders do not have the luxury of utilizing an asset light approach in every market.

Chart 29: Y/Y Change in Land Prices by Region



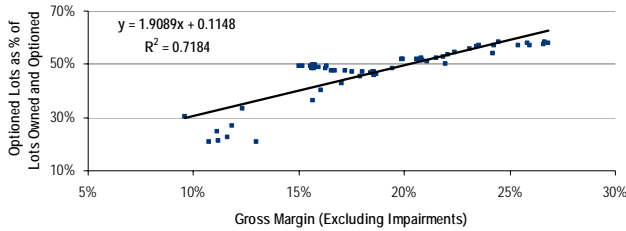
Source: Lincoln Institute of Land Policy, Graaskamp Center at the Wisconsin School of Business and BofA Merrill Lynch Global Research Estimates

Option contracts typically make more sense than direct land purchases or joint ventures and builders with a higher optioned lot mix tend to achieve better gross margins and ROIC

Rolling into option contracts

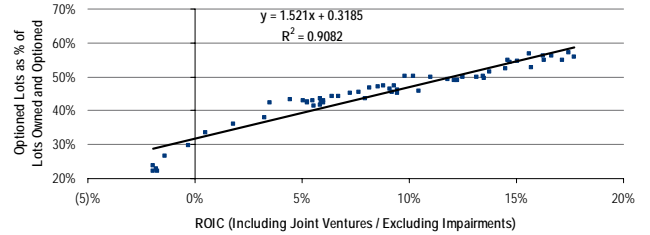
Most builders are seeking to acquire land through rolling option contracts, which allow a small number of lots to be purchased on a monthly or quarterly basis over a few years (usually no more than 18-24 months). Option agreements provide more flexibility in terms of inventory management as the only cost to a builder that elects to cancel an option contract is the loss of deposit payments, which typically amount to less than 10% of the purchase price. We also think options make more sense than joint ventures given the administrative burden and counterparty risk that exists with those types of relationships. The only exceptions would be land that a builder would not otherwise be able to access without engaging in a joint venture or for projects that have a lot of speculative units by definition (e.g. mid- and high-rise buildings where not all units can be pre-sold) and therefore create a need for risk diversification. The positive correlation between optioned lot mix and both gross margins and ROIC support our view that option contracts make the most strategic sense.

Chart 30: Optioned Lots versus Gross Margin for 1995 - 2009



Source: Company Reports and BofA Merrill Lynch Global Research Estimates

Chart 31: Optioned Lots versus ROIC for 1995 - 2009



Source: Company Reports and BofA Merrill Lynch Global Research Estimates

Table 27: Optioned Lots as % of Total Lots

Company	Most Recent Quarter	Historic (1995 - 2009)		
		Average	Maximum	Minimum
HOV	41%	55%	75%	19%
MDC	29%	37%	51%	23%
KBH	24%	41%	54%	22%
Industry Average	20%	46%	57%	18%
RYL	20%	50%	64%	17%
DHI	19%	45%	64%	17%
TOL	16%	36%	49%	13%
BZH	15%	50%	63%	17%
PHM	11%	50%	60%	13%
LEN	8%	37%	65%	12%

Optioned Lots do not include lots available through joint ventures
Source: Company Reports

Options have historically accounted for 46% of total controlled lots, although the mix is only 20% now because companies have been able to cancel option contracts more aggressively than selling land on their balance sheets. Many land sellers in this environment (particularly regional banks) would prefer to sell land in bulk rather than via option contracts, although the limited number of available buyers other than public homebuilders suggests that sellers do not have much negotiating leverage currently. The net result is that homebuilders have had more success engaging in option contracts coming out of this downturn relative to past cycles but we expect outright land purchases to become necessary as market conditions improve.

Looking at the role of government Gauging the impact of foreclosures

Table 28: States with Highest % of At Risk Mortgages

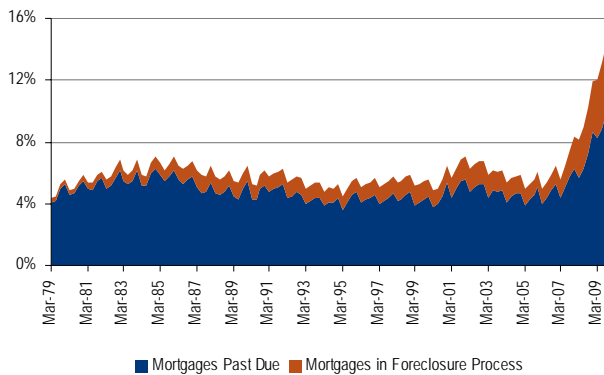
State	Region	% of Mortgages Past Due	% of Mortgages in Foreclosure Process	% of Mortgages At Risk
Florida	South	12.2%	12.7%	24.9%
Nevada	West	14.0%	9.4%	23.4%
Arizona	West	11.9%	6.2%	18.1%
Mississippi	South	14.4%	2.8%	17.2%
Michigan	Midwest	12.6%	4.5%	17.1%
Georgia	South	12.9%	3.5%	16.4%
California	West	10.5%	5.8%	16.3%
Indiana	Midwest	11.8%	4.0%	15.8%
Illinois	Midwest	10.5%	5.3%	15.7%
Ohio	Midwest	10.7%	4.6%	15.3%
Top At Risk States		12.2%	5.9%	18.0%
United States		9.9%	4.5%	14.4%

Data is as of September 2009

Source: Mortgage Bankers Association

We estimate 3-4mn foreclosed homes could be held by financial firms but we expect the sale of those homes to be orderly such that market equilibrium is not materially impacted at any point

Chart 32: At Risk Mortgages as % of Total Mortgages



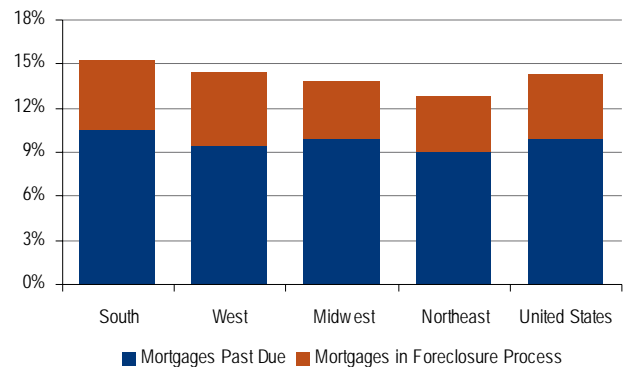
Source: Mortgage Bankers Association

Mortgage foreclosures have historically had more of an impact on existing rather than new home sales given the more frequent need to sell an existing residence relative to new homebuyers

An estimated 25% of mortgages in the United States carry negative equity value and 30-40% of home sales during 2009 were completed at prices below the remaining mortgage balance. The 25% carrying negative equity value includes 14% of total mortgages that we would consider to be at risk of foreclosure. The at risk portion includes 10% of mortgages that are at some stage of delinquency on monthly payments (ranging from 30 to 90 days) and 4% that are currently going through the foreclosure process. By comparison, 6% of mortgages have historically been at risk at any given time with delinquencies and ongoing foreclosures accounting for 5% and 1%, respectively. The at risk mortgages account for as much as 15 months of home sales at the current pace, although that figure assumes that no house carries multiple mortgages and therefore is an overly conservative estimate.

We estimate that the 10 states with the highest rate of at risk mortgages account for 53% of total at risk mortgages nationally. Florida, Nevada and Arizona are the three states carrying the most at risk mortgages, which explains why the South and West face the highest proportion of at risk mortgages across the country. The number of properties held by banks and other financial institutions (cases where the foreclosure process is complete) could be as high as 3-4mn currently, which equates to 9-10 months worth of home sales based on the existing run rate of 5mn units sold annually. Large banks have generally been unwilling to sell properties at currently depressed prices and therefore we do not expect all of this supply to come to market in 2010, which should ensure a more orderly absorption of these homes into the market in future years.

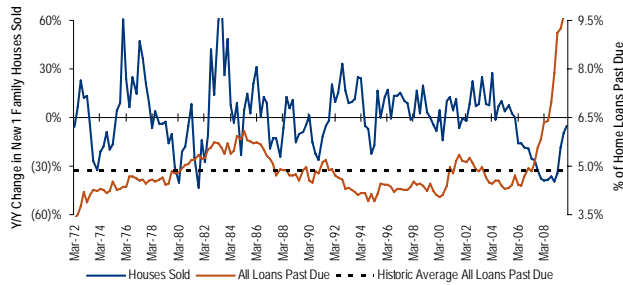
Chart 33: 3Q09 At Risk Mortgages as % of Total Mortgages by Region



Source: Mortgage Bankers Association

Our analysis suggests that mortgage foreclosures have historically had more of an impact on existing rather than new home sales volumes, which we expect to continue in the current cycle. We also expect foreclosures to weigh on pricing more than sales volume, which explains why we are modeling healthy 2010 volume growth but no price improvement until 2011. The impact of foreclosures on existing home sales can be explained by the fact that many individuals who are seeking to purchase an existing home typically own their previous residence. Foreclosures weigh on the price that the previous residence can be sold for, which is typically the primary source of capital to purchase the next home and therefore limits existing home sales volume. In contrast, 50% of new home sales are geared toward first-time buyers who do not own their previous residence.

Chart 34: Y/Y Change in New Houses Sold versus Loans Past Due



Source: Haver Analytics

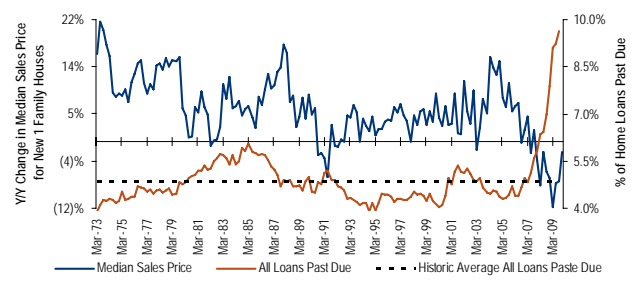
New home sales are also insulated from foreclosures to an extent given the capital needs and risks that come with foreclosed homes

Foreclosures are more likely to have an impact on new home pricing than volumes given the inclusion of foreclosed properties in the appraisal process

The government's loan modification program should allow for a more manageable level of foreclosures and a more orderly liquidation of those homes

Other government stimulus programs include a tax credit for homebuyers, purchases of mortgage backed securities, tax refunds for homebuilders and the extension of conforming loan limits

Chart 35: Y/Y Change in House Prices versus Loans Past Due



Source: Haver Analytics

We do not think foreclosed properties will significantly weigh on new home sales volumes for a number of reasons other than the fact that new home sales are geared toward first-time buyers. These reasons include: (1) rehabilitation work is generally required on foreclosed homes and these costs can not be financed as part of a primary mortgage (2) foreclosed property purchases typically require a higher down payment in cash to assure banks that a transaction will likely be completed (3) warranties are available for new home purchases but generally not for foreclosed properties (4) brokers tend not to promote foreclosed properties to the same extent as new homes because of the longer lead time to complete foreclosure sales and (5) many foreclosures are clustered within each market and most prospective buyers do not want to live amid unoccupied homes.

Foreclosures should continue to weigh on pricing through their impact on the appraisal process as foreclosed properties are used as benchmarks for appropriate market value. Current estimates are that as many as 25% of new home sales are weighed on by lower than anticipated appraisals due to foreclosed properties in the area, which can trigger a higher down payment requirement. The government is addressing foreclosures via its Home Affordable Modification Program (HAMP), which is designed to help at-risk homeowners avoid foreclosure through monthly mortgage payment reductions. We think HAMP has allowed for a more orderly foreclosure market such that a wave of inventory is unlikely to be liquidated at a single point in time over the next few years. This likelihood reinforces our view that foreclosures should not have a meaningful impact on new home volumes but could affect pricing for now.

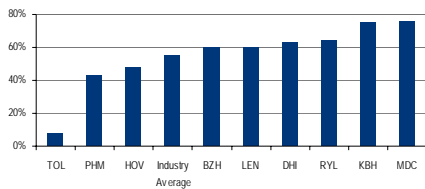
HAMP has yielded 900k loan modifications on a trial basis since inception in February 2009, which compares to an addressable opportunity of 2-3mn mortgages that are at least 60 days delinquent. The program is slated to expire at the end of 2012 and provides monetary incentives to mortgage servicers and investors to reduce the interest rate (floor of 2%), extend the loan term (ceiling of 40 years) or offer forbearance (no interest paid on certain portion of principal). Although the conversion from trial to permanent modifications has been low to date, we do not think the political environment would currently allow for most of these modifications to result in foreclosed properties.

Other stimulus efforts will unwind eventually

The government has played an increasingly high profile role in the homebuilding market in a number of other ways over the past few years. Although some of these programs are expected to be wound down in the foreseeable future, we think the mid-term elections later this year suggest a desire to ensure sufficient stimulus remains in place to avoid further deterioration in market conditions.

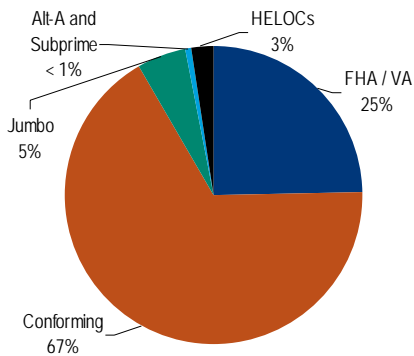
The tax credit may have accounted for 12-14% of sales during 2009 but economic growth should minimize the demand slowdown once the credit terminates

Chart 36: 2009 Government Insured or Guaranteed Loans as % of Total Mortgages



Source: Company Reports and BofA Merrill Lynch Global Research Estimates

Chart 37: 2009 Issuance of Single Family Residential Mortgage Loans



Source: BofA Merrill Lynch Global Research Estimates and Inside MBS and ABS

Changes to FHA criteria and standards pose the biggest risk to new home demand in terms of government involvement

Government efforts over the past few years have included:

- An \$8k tax credit for first-time homebuyers and a \$6.5k credit for existing homebuyers under various limitations tied to income and home prices, which requires a contract to be signed by April 30 and the home purchase to be completed by June 30
- Federal Reserve program to purchase \$1.25tn of mortgage backed securities issued by government agencies (e.g. Fannie Mae, Freddie Mac), which is intended to hold down mortgage interest rates and will be concluded in 1Q10
- Operating losses generated during fiscal years that began during calendar year 2008 or 2009 can be carried back up to five years (versus two years previously) to offset income for tax refund purposes
- Extending the definition of conforming loan limits that increases the size of mortgages that Fannie Mae can purchase from \$417k to as much as \$729.75k in high cost areas of the country

Some estimates peg the benefit of the tax credit at 600-700k home sales during 2009 (12-14% of total sales), although the mix between new and existing homes is unclear. Although the tax credit has created an undeniable catalyst for transactions during 2009 that may have pulled in some demand from 2010, we think the economic recovery will allow for a fairly smooth transition from tax credit driven buying to organic demand growth. The impact on interest rates from Federal Reserve purchases will also dissipate over the next few months, although our analysis suggests that employment has more influence than the cost of capital on prospective buyers.

Understanding the role of the FHA

The primary risk to new home demand in terms of government involvement is the role of the Federal Housing Administration (FHA) in our opinion. The FHA provides mortgage insurance that allows lenders to bear less risk, which results in lower interest rates and 96.5% financing eligibility for homebuyers. FHA targets lower income homebuyers and therefore a large portion of insured loans have been extended to first-time purchasers. The absence of willing lenders to the sub-prime market over the past few years has resulted in the FHA accounting for 25% of single family residential mortgage issuance during 2009 and closer to 50% of mortgages for purchases (excludes refinancings). FHA loans currently account for 55% of mortgages extended to customers of the public homebuilders with a range of 76% for MDC and 8% for TOL.

The FHA currently has reserves of 0.5% to cover insured loans versus a government mandated 2% minimum, which explains why the FHA recently announced a 50bp increase to insurance premiums paid by borrowers and 90% financing limits for the lowest credit quality borrowers (credit scores below 580 versus a 680 average for all FHA borrowers). These measures should not have a material impact on borrower eligibility but any decisions by Congress to raise down payment requirements across all prospective FHA insured buyers (current proposals include an increase from 3.5% to 5% down payment) could dampen demand. Given the current political environment and upcoming mid-term elections, we think any structural changes to FHA eligibility criteria and financing limits are unlikely.

Keeping an eye on capital structure What is optimal leverage for a homebuilder?

Homebuilders are currently holding cash that equates to 60-70% of debt and industry leverage of 67% is above the 45-50% target of most companies

Credit facilities are only being used for letters of credit currently and we think a revolver is appropriate to utilize for short term construction costs but not land purchases

Homebuilders carry average debt / capital of 67% currently, although leverage levels would be 56% excluding BZH and HOV. The historic average of 54% is fairly consistent with the 45-50% target of most companies. Net debt / capital is 33% currently, which implies that homebuilders are holding an average of 60-70% of their respective debt balances in cash. MDC is the only company carrying a negative net debt balance so the industry average would be 49% excluding its contribution. We think the mix of debt can be as critical as absolute leverage levels given the importance of matching up the duration of assets and liabilities.

Only five out of the eight companies we cover have a revolving credit facility currently and none are using those facilities for anything other than letters of credit. We think revolving credit should be used exclusively to fund short term construction costs given the opportunity to quickly monetize the investment through a home sale. In contrast, land purchases can represent longer duration assets that require fixed financing in the form of equity and bond issuance. The combination of banks' risk aversion and homebuilders' ample liquidity suggest that the use of credit facilities will not become prevalent for the foreseeable future, although a sustained market recovery could change that dynamic.

Table 29: Total Debt / Capital

Company	Most Recent Quarter	Historic (1995 - 2009)		
		Average	Maximum	Minimum
HOV	123%	65%	123%	48%
BZH	86%	54%	91%	39%
KBH	72%	61%	75%	45%
Industry Average	67%	54%	68%	44%
RYL	60%	56%	79%	35%
PHM	57%	50%	66%	40%
LEN	55%	49%	66%	38%
DHI	53%	54%	65%	41%
MDC	49%	44%	66%	28%
TOL	46%	49%	58%	39%

Source: Company Reports

Equity investors seem to be comfortable with debt / capital of 45-50% based on the relationship between stock multiples and leverage over time

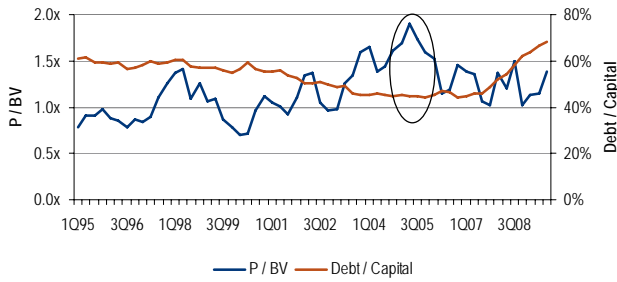
Table 30: Net Debt / Capital

Company	Most Recent Quarter	Historic (1995 - 2009)		
		Average	Maximum	Minimum
HOV	132%	64%	132%	47%
BZH	81%	52%	88%	31%
KBH	48%	57%	72%	31%
PHM	43%	46%	56%	37%
LEN	38%	44%	65%	24%
Industry Average	33%	48%	60%	27%
DHI	28%	51%	62%	35%
RYL	16%	49%	78%	22%
TOL	8%	41%	56%	8%
MDC	(99)%	25%	64%	(161)%

Source: Company Reports

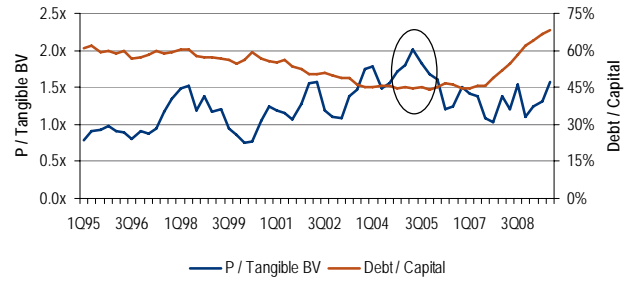
Debt / capital for the industry reached a low of 44% in 2005, which coincided with peak P / BV and P / Tangible BV multiples of 2x. A number of factors contributed to valuation during that time, although leverage and multiples have exhibited a consistent inverse correlation historically. Equity investors therefore appear to view optimal leverage as 45-50% in the homebuilding industry, which makes sense in terms of balancing returns on investment with business cycle volatility.

Chart 38: Industry Comparison of P / BV and Debt / Capital



Source: Company Reports and BofA Merrill Lynch Global Research Estimates

Chart 39: Industry Comparison of P / Tangible BV and Debt / Capital



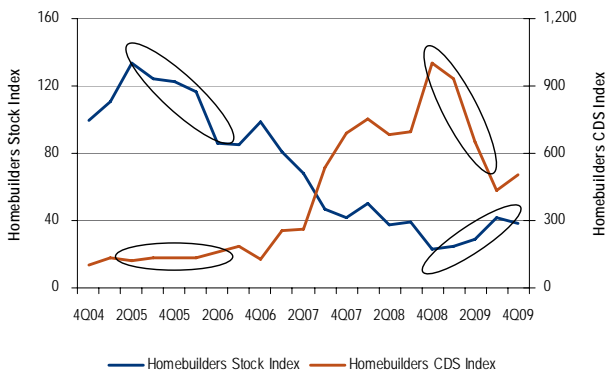
Source: Company Reports and BofA Merrill Lynch Global Research Estimates

Homebuilding stocks led credit default swap prices going into the downturn but swap pricing has led during the ensuing recovery

Equity and debt switched leadership roles

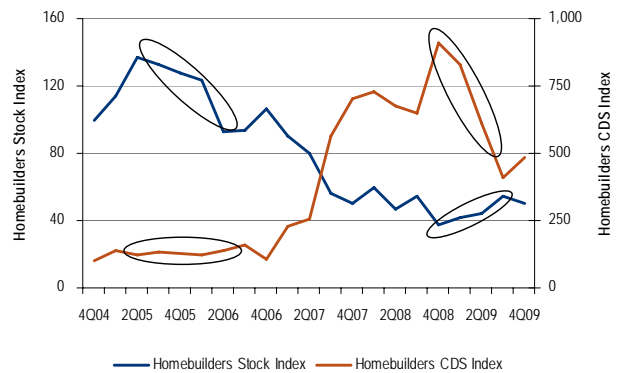
A comparison of stock and credit default swap (CDS) pricing since 2004 illustrates some inconsistencies in terms of which asset class leads the other. Homebuilder stocks exhibited a much sharper downturn than CDS instruments in 2005 when the market first discounted the cycle peak, although CDS pricing has reflected more optimism since the market bottom in early 2009. We think this optimism may partially be a function of the cash balances that companies have built through cost savings, land sales and tax refunds such that liquidity concerns have largely dissipated at this point. In contrast, the stocks seem to be struggling with discounting the timing and trajectory of the recovery, which we view as an opportunity for investors. Homebuilding stocks remain 60-70% below peak levels while CDS prices are 400% above the trough of five years ago.

Chart 40: Comparison of Stock and CDS Prices (Unweighted)



Stock index and CDS index are both equal weighted
Source: Bloomberg and BofA Merrill Lynch Global Research Estimates

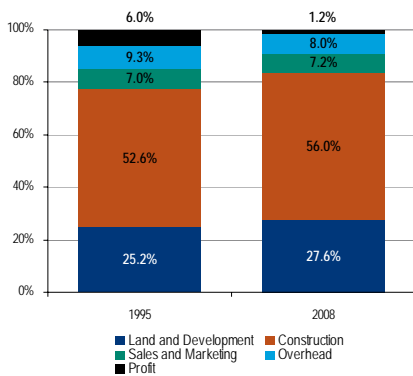
Chart 41: Comparison of Stock and CDS Prices (Weighted)



Stock index is weighted based on market capitalization while CDS index is weighted based on debt balance
Source: Bloomberg and BofA Merrill Lynch Global Research Estimates

The basics of homebuilding A local business at its core

Chart 42: General Costs as % of Sales Price



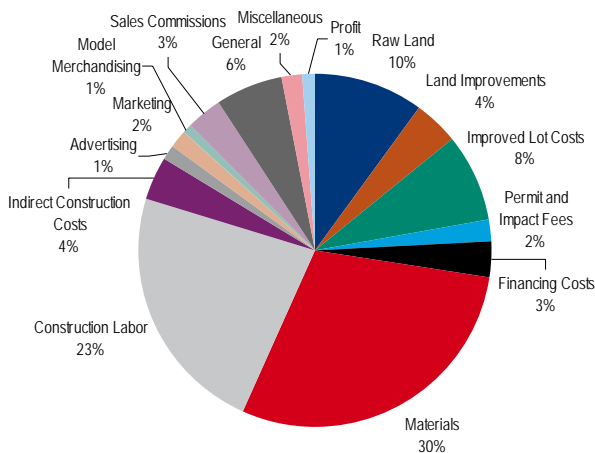
Source: Professional Builder Magazine

Land and development spending account for 25-30% of the home purchase price but land selection is the most important factor in determining margins and sales velocity

Land and development spending have accounted for 25-30% of the average home purchase price over the past 15 years, which is equivalent to half of the cost associated with actual home construction. Sourcing appropriate lots is the most critical element to achieving adequate returns on capital in our view and this process has and will always be localized in nature. Local knowledge is necessary in terms of gauging appropriate locations based on ease of commuting and accessibility to shopping centers among other factors. Local relationships are also important in facilitating community approvals for land use, which entails the entitlement or zoning process (what the land can be used for), verification of the specific site plan (what types of structures will be built) and construction permits. Entitlement and permitting can require less than one year in states such as Texas and as long as 5-10 years in coastal markets such as California and New Jersey with steps in the process differing somewhat by community.

Builders have achieved what we believe are permanent efficiencies in terms of materials usage but recent reductions in construction times from 4-6 months in the past to 3-4 months currently are cyclical benefits at best in our opinion. Our analysis suggests that materials account for 30% of total construction costs while labor (23%) and land development (27% when aggregating raw land purchases, improvement expenditures and financing costs) are the other major components. The lack of sustained improvement beyond materials usage underscores why gross margins over the past five years (excluding impairments) have not improved from the 18% level achieved in the early 1970s.

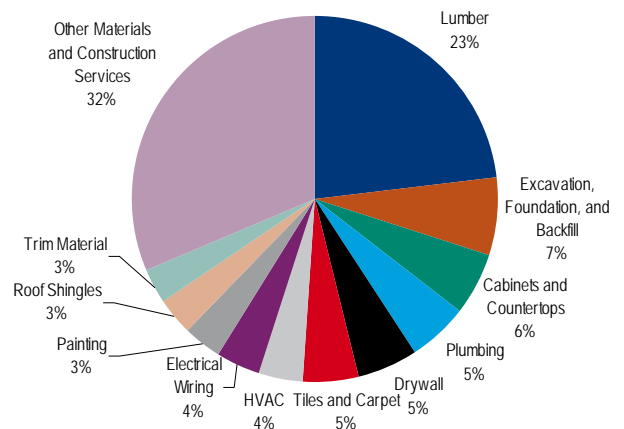
Chart 43: Specific Homebuilding Costs as % of Sales Price



Source: Professional Builder Magazine

Homebuilders have achieved sustainable efficiencies with respect to materials sourcing and usage but labor savings will likely prove cyclical at best

Chart 44: Components of Construction Labor and Materials



Source: National Association of Home Builders and BoFA Merrill Lynch Global Research Estimates

Most large builders have engaged in national vendor agreements for specialized products such as appliances, cabinets and countertops, heating and cooling systems and windows, which have yielded economies of scale purchase benefits. This initiative has coincided with an effort to reduce the number of floor plans offered, eliminate unnecessary square footage and standardize certain aspects of home design such as placement of plumbing and electrical systems. These efforts have resulted in reduced material usage and will likely be sustainable in the first time market where home designs tend to be more homogeneous. Commodity products such as lumber have a more fragmented supply chain that allow for competitive local bidding such that national contracts are not necessary.

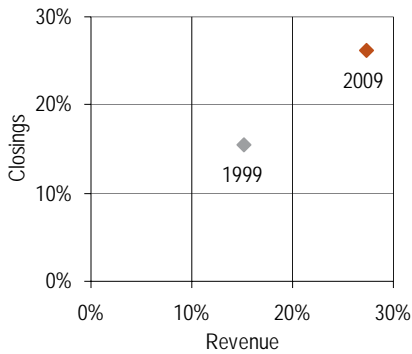
Separating labor and materials spend makes sense where feasible but the builders are generally at an embryonic stage in terms of disaggregation

The challenges associated with achieving sustained labor efficiencies explain why the even flow production that has been embraced by some builders will not be feasible over the long term

Builders exclusively utilize subcontractors for all construction work and these agreements historically included bundled pricing for labor and materials. Some companies are now focused on disaggregating the components in order to reduce vendor costs, which makes sense when feasible. Broad disaggregation is at an embryonic stage and there are certain areas of the country such as California where separation does not appear possible because of the nature of the vendor base. We also expect separation to become more difficult once construction activity picks up and subcontractors have more negotiating leverage with builders. The prospects for a pick up also explain why construction times could begin to inch back toward six months. One of the primary swing factors for completion times is the expediency of inspections done by local authorities, which can be a source of delays when there is more demand for their services.

The net result is that even flow production is not sustainable throughout a cycle in our opinion, which is a methodology that has been embraced by PHM, KBH and LEN in particular. Even flow is designed to have subcontractors move from lot to lot with minimal downtime in between so the contractor can optimize its workforce while the builder can more effectively manage its labor costs (e.g. limit overtime). Even flow requires a transparent backlog and is more conducive to a build-to-order model, although cancellations during downturns and competitive demands for subcontractors during upturns suggest to us that even flow may only be viable during periods when demand is at a plateau and not at inflection points.

Chart 45: Revenue and Closings Market Share for Largest Public Companies



Largest public companies include BZH, DHI, HOV, KBH, LEN, MDC, MTH, NVR, PHM, RYL, SPF and TOL
Source: BofA Merrill Lynch Global Research Estimates

Small builders have lost share due to a lack of capital availability but should retain a niche in the luxury and urban in-fill parts of the business

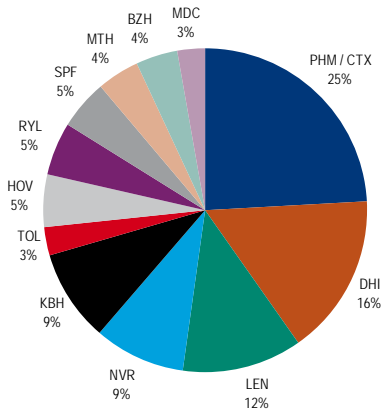
The large get larger but fragmentation remains

We estimate that all publicly traded companies account for 33% of the \$100bn homebuilding market in terms of revenues and homes delivered with private companies accounting for the balance. The 13 largest public builders generate 27% of home closings and 26% of revenues currently, which is up from 15% in 1999 on both measures. The share gains for large builders stemmed from acquisition activity earlier in the decade, although share consolidation more recently has come from the lack of capital availability for smaller builders. Banks have generally not been willing to extend financing to builders that do not have signed sales contracts in hand and the markets in which small builders tend to compete carry additional risks that have limited capital availability.

Many small builders compete in the luxury and urban in-fill markets (in areas such as the Northeast) where land purchases and development costs can account for as much as 40-50% of home sales prices (25-30% nationally). Urban in-fill projects are typically multi-family structures where some speculative units exist by definition as the building is constructed before all units are pre-sold. The combination of higher upfront land costs, the nature of urban in-fill projects and the thinly capitalized status of many privately owned builders explain why banks have not been willing to extend capital. The large public builders are focused on the first-time and first move-up market currently and we expect share gains to continue in those segments, although smaller builders should retain a niche in the luxury and more urban parts of the country.

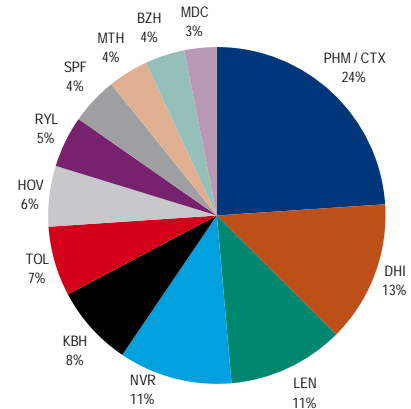
17 February 2010

Chart 46: 2009 Market Share Amongst Largest Public Companies Based on Closings



Data reflects trailing 12 months as of September 2009
Source: Company Reports

Chart 47: 2009 Market Share Amongst Largest Public Companies Based on Revenues

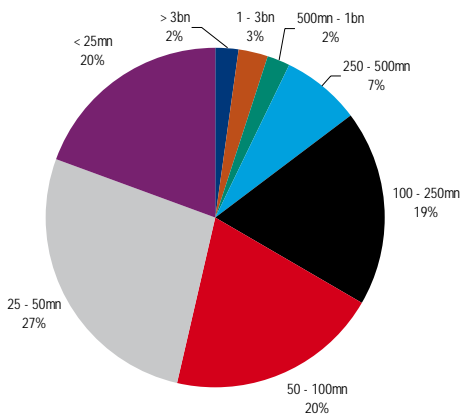


Data reflects trailing 12 months as of September 2009
Source: Company Reports

The industry is fairly fragmented as only three public builders have more than a 10% share while 67% of all builders (public and private) generate less than \$100mn of revenue annually

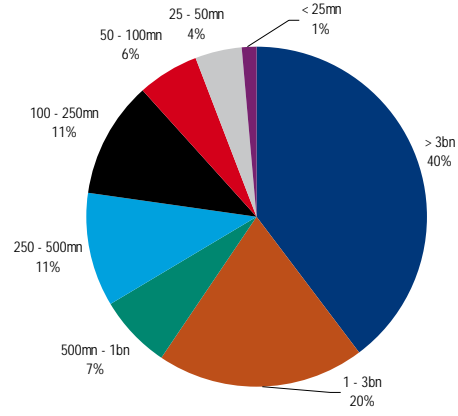
PHM and CTX collectively account for 25% of the market among large public builders while DHI and LEN are the only other companies that carry more than a 10% share of both closings and revenue. Fragmentation exists even within the 27% of the market occupied by the largest public builders as seven of the 12 companies carry a share of 5% or less. This fragmentation is also evident in the distribution of revenues throughout the industry as 67% of companies generate less than \$100mn of revenue.

Chart 48: Distribution of Revenue per Company Based on Number of Companies



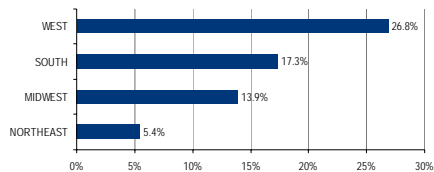
Source: Professional Builder Magazine Giant 400 List

Chart 49: Distribution of Revenue per Company Based on Revenue Generated



Source: Professional Builder Magazine Giant 400 List

Chart 50: Regional Market Share for Largest Public Companies



Largest public companies include BZH, DHI, HOV, KBH, LEN, MDC, PHM, RYL and TOL

Market share is calculated based on number of homes closed / regional permits issued in the 50 largest metropolitan statistical areas
Source: Builder Magazine

The largest public companies have the greatest concentration of share in the West and South, which does not come as a surprise. The first-time and first move-up markets account for a larger portion of new home sales in these regions, which are the customer profiles being targeted by most of the large builders. We estimate that PHM / CTX leads the industry with a 9% share in the West and a 5% share in the South. In contrast, the largest builders have a 14% share in the Midwest and only account for 5% of the market in the Northeast. We think private builders occupy a large footprint in the Northeast in particular, which explains why TOL leads the market amongst the public builders with less than a 2% share.

Table 31: Regional Market Share by Company

Company	Midwest	Northeast	South	West
BZH	1.3%		0.5%	0.8%
DHI	2.1%	0.2%	3.6%	6.9%
HOV	1.4%	1.6%	1.2%	0.9%
KBH			2.2%	3.8%
LEN	0.9%	0.9%	2.7%	3.1%
MDC			0.1%	2.6%
PHM / CTX	6.1%	1.0%	5.2%	8.8%
RYL	2.1%		1.4%	
TOL		1.7%	0.4%	
Total	13.9%	5.4%	17.3%	26.8%

Bolded and shaded cells reflect market leader within each region

Source: Builder Magazine

Glossary of terms

- **Absorption rate:** Calculation of the number of homes sold per community during a given timeframe (per month, quarter or year) that is a gauge of how efficiently a builder is leveraging its overhead cost.
- **Active adult buyer:** These buyers are generally at or near retirement age and are typically seeking smaller homes in communities that are more self-contained and may offer various amenities (e.g. golf course).
- **Cancellation rate:** The number of signed contracts cancelled during a quarter divided by either the number of gross orders recognized during the quarter or the beginning of period backlog.
- **Community:** Homebuilders define communities in slightly different ways but generally a community is defined by a collection of housing units within close proximity that all address the same end market (e.g. first-time, move-up, active adult).
- **Community sell through:** A measure of how long is required to sell all of the homes in a community, which can vary from less than a year to a decade depending on number of homes and targeted buyer.
- **Finished lot:** A lot that is ready for a home to be built after all development work has been completed.
- **Home delivery:** Builders count a finished home as being delivered when a certificate of occupancy has been issued and title for the property has been transferred to the buyer.
- **Housing permits:** Housing units that are authorized in local jurisdictions by a building or zoning permit. A major portion of housing units get under way during the month of permit issuance and most of the remainder begin within the following three months.
- **Housing starts:** Starts signify when excavation begins for the footings or foundation of a building and all housing units in a multi-family building are defined as being started when excavation for the building has begun.
- **Inventory:** Land and homes (either finished or under construction) that builders recognize on their balance sheets. The cost of land purchases, development and home construction are capitalized into inventory until the home is sold.
- **Land development:** Costs required to advance land to the point where a home can be built, which include the entitlement (designating the land for residential construction) and permitting process, removal of trees and dirt and the installation of roads, utilities and other basic infrastructure.
- **Move-up buyer:** These buyers can be segmented into first and second move-up based on stage in life, price and home size. First move-up buyers are seeking to increase their living space but remain price conscious while second move-up buyers are also seeking larger accommodations but tend to be more luxury oriented.

- **Multi-family product:** Units within a community that are typically attached to each other such as townhouses or condominiums.
- **Order:** A signed contract with a homebuyer that typically requires an initial down payment and completion of a pre-qualification mortgage review process.
- **Single family detached product:** Units within a community that are free standing and are constructed to accommodate single families.
- **Speculative inventory:** Homes that are either under construction or finished that are not covered by a sales contract. Builders will intentionally build speculative homes in anticipation of demand or recognize a home as speculative if a sales contract covering the unit is cancelled by the buyer.
- **Short sale:** A sale of a house in which the proceeds fall short of what the owner still owes on the mortgage, which is most common when the homeowner is facing foreclosure.
- **Urban in-fill:** Housing units that are built in more densely populated areas and are usually mid- or high-rise structures (apartment buildings).
- **Years of land supply:** Calculated by dividing the number of lots owned or under option contracts by the number of deliveries over the past 12 months to gauge how much land a builder has remaining based on the current sales pace.

Investment thesis

Beazer Homes

Our Neutral rating on BZH assumes that lingering concerns about leverage and upcoming debt maturities will offset anticipated volume growth, which will be driven by exposure to first-time buyers and speculative units. However, BZH faces more debt maturities through F2013 than its current cash balance, which suggests that financial leverage may impact its operational strategy. This impact would be reflected in limited land and development spending that may prevent BZH from addressing demand.

DR Horton

Our Buy rating on DHI assumes a disproportionate benefit from the current federal homebuyer tax credit due to its use of a speculative home construction strategy and positioning in markets (e.g. Texas) where first-time homebuyers are prevalent. An increased focus on acquiring finished land, a more favorable cost structure than peers and the potential for more volume growth in F2010 tied to the tax credit should yield above average returns on equity and invested capital.

Hovnanian Enterprises

Our Buy rating on HOV assumes ample balance sheet flexibility to capitalize on the expected industry recovery over the next few years. The homebuyer tax credit should boost volume growth tied to the 45% of HOV's revenue from first-time purchasers while a willingness to increase speculative unit count should also boost deliveries over the next few quarters. This benefit will yield improving margins and returns on capital from levels that are currently the lowest among HOV's major peers.

KB Home

Our Buy rating on KBH assumes the Open Series product line will appeal to the first-time homebuyer and will therefore yield volume growth in F2010, which is the healthiest segment of the market currently. The centralized nature of KBH allows the company to effectively tie an asset light and build-to-order strategy together, which should result in above peer average returns on capital and multiple expansion.

Lennar

Our Buy rating on LEN assumes favorable volume growth in F2010 from exposure to the first-time market and an elevated backlog conversion ratio due to above average speculative units. Volume growth should be driven by the homebuyer tax credit and improving economic conditions during the second half of the year while distressed investments could help boost margins. Returns on capital should reach positive territory during F2010 and justifies some multiple expansion.

MDC Holdings

Our Buy rating on MDC assumes the company will disproportionately benefit from housing demand in F2010 given the company's focus on first-time buyers and its speculative home construction strategy. The company carries the lowest land supply versus peers that should result in minimal impairments while ample cash will allow for opportunistic land purchases in markets that yield appropriate asset turnover. Improvement in returns on equity and invested capital should yield multiple expansion.

Pulte Homes

Our Buy rating on PHM is driven by cost synergies, revenue diversification and volume growth in the first-time buyer segment as a result of the merger with Centex. Our gross margin estimates could prove conservative based on the magnitude of merger related purchasing and production efficiencies that were not part of the initial phase of integration. Anticipated upside is likely to stem from better than expected returns on equity and invested capital rather than significant multiple expansion.

Ryland Group

Our Buy rating on RYL is predicated on operating leverage that is derived from a land light model and an ability to monetize demand from first-time buyers (healthiest portion of the market) through construction of speculative units. RYL is actively purchasing finished lots that offer attractive valuations and limited impairment risk. We expect improvement in returns on equity and invested capital to lead to multiple expansion.

Toll Brothers

Our Underperform rating on TOL is driven by economic challenges and limited financing options that will continue to weaken demand in the luxury market. Margin compression will come from volume declines and will be magnified by quick turn sales and ongoing changes in product mix. The expected slowdown in the luxury market versus relative stability in the first-time segment could result in TOL being the only company in our coverage universe that faces deteriorating returns in the next year.

Price objective basis & risk

Beazer Homes (BZH)

Our \$4.50 price objective is predicated on a two-pronged framework that assumes higher ROE and ROIC will equate to higher multiples. BZH's returns should improve over the next year, although ROE and ROIC will remain among the lowest in the peer group that is a function of capital structure concerns. Our framework implies no improvement in the current EV / IC multiple of 0.8x versus 0.9x historically or P / tangible BV (net of cash) multiple of (1.6)x versus 0.6x historically. Downside risks to our rating and price objective are refinancing and liquidity challenges, incremental impairments, high foreclosure rates in the West and South regions and continued costs associated with legal issues. Upside risks are better than expected volume driven by first-time homebuyer demand tied to tax credit stimulus, the rolling out of an environmentally friendly line of homes and the effective use of a speculative build strategy.

DR Horton (DHI)

Our \$16 price objective is predicated on a two-pronged returns-based framework that assumes higher ROE and ROIC will equate to higher multiples. We expect the P / tangible BV (net of cash) to expand from 0.4x currently to 0.7x versus an average of 0.5x historically. We also expect EV / IC to expand from 1.1x to 1.3x versus an average of 1.1x historically. Multiple expansion to above the historic average is justified given that DHI should exhibit some of the largest relative improvement in returns versus peers during F2010 and will be one of the few companies generating positive ROE and ROIC by year end based on our forecasts. Downside risks to our rating and price objective are continued impairments given above average land supply, high foreclosure rates in the Southwest and West regions that could weigh on growth and the implementation of more stringent underwriting standards by government agencies that back mortgages for low income homebuyers.

Hovnanian Enterprises (HOV)

Our \$5 price objective is predicated on a two-pronged returns-based framework that assumes higher ROE and ROIC will equate to higher multiples. Although improving returns should provide a catalyst for the stock, the more important driver will be the fact that market value is currently well below cash value (balance sheet cash and present value of deferred tax). We expect the P / tangible BV (net of cash) to improve from (3.1)x to (2.5)x versus an average of 1.5x historically. The forward EV / IC multiple of 0.9x currently should remain steady versus an average 1.0x historically. Downside risks to our rating and price objective are an equity offering in order to delever the balance sheet, continued impairments given HOV's above average land supply and legacy land holdings, exposure to the second move-up market segment and high foreclosure rates in the Southeast and West regions.

KB Home (KBH)

Our \$20 price objective is predicated on a two-pronged returns-based framework that assumes higher ROE and ROIC will equate to higher multiples. In addition to improved returns over the next year, multiple expansion for KBH should also be driven by the fact that equity market value is currently below cash value (cash on balance sheet and present value of deferred tax). We expect P / tangible BV (net of cash) to improve from 0.0x currently to 0.8x versus 1.6x historically and EV / IC to improve from 1.1x to 1.2x versus an average of 1.3x in the past. Downside risks to our rating and price objective are a less than anticipated benefit from tax credit driven demand due to an aversion to speculative building, high foreclosure rates in the West and Southwest regions and the implementation of more stringent underwriting standards by government agencies.

Lennar (LEN)

Our \$21 target is predicated on a two-pronged returns-based framework that assumes higher ROE and ROIC will equate to higher multiples. We expect P / tangible BV (net of cash) to improve from 0.5x to 0.9x (historic average of 1x) and EV / IC to hold at 0.9x (historic average of 1x). LEN is one of only three builders that should generate positive returns by the end of F2010, which warrants multiples approaching the historic average in our opinion. Downside risks to our rating and price objective are incremental impairments to existing land holdings, headline risk due to recourse exposure to legacy joint ventures and high foreclosure rates in the West region that could lead to price pressure beyond our current expectations.

MDC Holdings (MDC)

Our \$43 price objective is predicated on a two-pronged returns-based framework that assumes higher ROE and ROIC will equate to higher multiples. MDC should also exhibit multiple expansion due to the fact that market value is currently below cash value (cash on balance sheet and present value of deferred tax). We expect P / tangible BV (net of cash) to improve from (0.1)x currently to 0.3x versus a historic average of 0.9x and EV / IC to improve from 0.7x to 0.9x versus a mean of 1.0x in the past. Downside risks to our rating and price objective are continued high overhead costs, high foreclosure rates in the West region and implementation of more stringent underwriting guidelines by government agencies.

Pulte Homes (PHM)

Our \$14 price objective is predicated on a two-pronged returns-based framework that assumes higher ROE and ROIC will drive higher multiples. The stock already trades at P / tangible BV (net of cash) in line with its 0.8x historic average

while EV / IC is modestly above the mean of 0.9x since F1995. ROE and ROIC should improve at a faster pace than peers in F2010 and merger synergies should yield margin upside in excess what will be achieved by other national builders. Downside risks to our rating and price objective are high exposure to the weak second move-up market, an unsuccessful implementation of leveled production and the potential for incremental impairments given an above average land supply.

Ryland Group (RYL)

Our \$28 price objective is predicated on a two-pronged returns-based framework that assumes ROE and ROIC will drive changes in valuation multiples. We expect EV / IC to improve from 1.0x to 1.1x versus an average of 1.2x historically given anticipated improvement in returns on capital. P / tangible BV (net of cash) should increase from 0.2x currently to 0.7x versus 1x historically, although upside will be somewhat muted given that ROE is not expected to improve as much as ROIC. Downside risk to our rating and price objective are exposure to a weak second move-up buyer market, high foreclosure rates in the West and Southeast regions and implementation of more stringent mortgage underwriting standards by government agencies.

Toll Brothers (TOL)

Our \$16 price objective is predicated on a two-pronged returns-based framework that assumes changes in ROE and ROIC will drive valuation multiples. We are modeling returns over the next year to reach new historic lows since F1995 and therefore we expect P / tangible BV (net of cash) and EV / IC to both decline to new trough levels of 0.2x and 0.7x, respectively. By comparison, P / tangible BV (net of cash) is 0.4x currently and has been 1.3x historically while EV / IC is 0.9x currently versus a mean of 1.2x in the past. Downside risks to our rating and price objective are a further weakening of demand for luxury homes driven by limited financing availability, incremental impairments given significant land supply on the books and limited overhead cost absorption due to vertical integration. Upside risks to our rating and price objective are better than expected demand from the move-up buyer profile and a more favorable contribution from active adult projects.

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US-Homebuilders Coverage Cluster

Investment rating	Company	BofAML ticker	Bloomberg symbol	Analyst
BUY				
	DR Horton	DHI	DHI US	Jonathan Ellis, CFA
	Hovnanian Enterprises	HOV	HOV US	Jonathan Ellis, CFA
	KB Home	KBH	KBH US	Jonathan Ellis, CFA
	MDC Holdings	MDC	MDC US	Jonathan Ellis, CFA
	Pulte Homes	PHM	PHM US	Jonathan Ellis, CFA
	Ryland Group	RYL	RYL US	Jonathan Ellis, CFA
NEUTRAL				
	Beazer Homes	BZH	BZH US	Jonathan Ellis, CFA
UNDERPERFORM				
	Toll Brothers	TOL	TOL US	Jonathan Ellis, CFA

Important Disclosures

Investment Rating Distribution: Building Group (as of 01 Jan 2010)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	48	46.15%	Buy	18	39.13%
Neutral	30	28.85%	Neutral	5	19.23%
Sell	26	25.00%	Sell	6	24.00%

Investment Rating Distribution: Global Group (as of 01 Jan 2010)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1699	50.78%	Buy	904	58.82%
Neutral	841	25.13%	Neutral	491	65.03%
Sell	806	24.09%	Sell	368	49.80%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where BofAML Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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