Vector Strategy Group:

Strategic Report - KB Home

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Executive Summary

Founded over fifty years ago, KB Home competes in the United States homebuilding industry with a strong emphasis on first-time and first-move up homeowners. The Los Angeles based homebuilder holds a portfolio with exposure to four regions domestically as well as its own mortgage subsidiary. Governed by the principal of offering high quality houses at affordable prices, KB Home has a diversified offering of houses while delivering highly customized options to customers. The Fortune 500 company has been the best homebuilder three times in the previous four years on Fortune Magazine's *Most Admired Companies List*[1]. However, the housing market has recently complicated business for KB Home.

The homebuilding industry has experienced a rough few years since the beginning of the economic contraction, which brought about the explosion of the housing bubble and deleveraging on the balance sheet of the consumer. KB Home and the homebuilding industry has faced much adversity over the past few years with mortgage defaults, increased foreclosures, and saturated housing inventories. Though a housing recovery is nowhere in the immediate future, with the aid of strong government stimulus and policy as well as other indicators of stabilization in the economy conditions are slowly improving. With goals to help correct the market, government policy and stimulus has come in numerous forms: low interest rates, mortgage buyback programs, and tax credits to first-time homebuyers.

KB Home will continue to face tight competition in the wide-scoped homebuilding industry from both public and private homebuilders. KB Home has been well positioned relative to competitors with respect to its business model, however, has faced more adversity with over-exposure in many significantly depressed housing markets. Further emphasizing the importance for KB Home to continue to properly maneuver in the housing market, recent years have forced several hundreds of homebuilders into bankruptcy, offering well-positioned companies to be beneficiaries of increased market share as the housing market and economy recover.

Though profitability may be extremely difficult for KB Home during 2010, the analysis will offer short term goals to maintain financial strength and positioning relative to its largest competitors, as well as offer a long term solution to help KB Home better manage risk and take advantage of a recovery. In the near future, KB Home must continue to focus on its first-time buyer demographic, take measures to increase cash, increase asset sales in distressed areas to make land purchases in growth regions, and maintain a "short land" position relative to its competitors. More long term goals include diversifying its portfolio with expansion into new geographical territories and further developing communities as a value-added complement to the houses it builds.

Company Overview

History

In 1957, Don Kaufman and Eli Broad founded Kaufman and Broad Building Company, the precursor to KB Homes, in Detroit Michigan. With an initial investment of USD$25,000, the cofounders sought out to develop 2 model homes in the Madison Heights suburb of Detroit. The business strategy lied in targeting the entry-level housing market, and endeavor that soon proved fruitful. In its first year in business, the company made $1.7 million in revenue, recuperating the cofounders' initial investment and earning them a net income of $33,000, solidifying the company's reputation as a well-positioned provider of well-designed and affordable first homes[2].

Given their entry success, Kaufman and Broad Building Co. expanded into the contract housing business in 1959, developing elderly housing and college dormitories as well as new homes for the armed forces and public housing agencies. This sector also proved a success, seeing sales triple from their first year in business to $5.1 million, and net income improving to 7 percent of sales.

Soon after, in 1961, the company went public, raising about $1.8 million in its IPO. In this period, it successfully made an incursion into the Arizona home market, doubling its total revenue from two years prior to $11.7 million, while achieving a net income of more than 5 percent of sales. Pursuing their success, and refusing to lose momentum, the company introduced a new product in Detroit called "Townehouses". It quickly became apparent that, the company understood the needs of the market well when it managed to sell 400 townhouse units in 30 days and shortly after become the first builder to successfully obtain financing commitments to provide qualified buyers with mortgage loans. Ultimately this growth explosion and new ventures in Southern California, San Francisco, Chicago and New York led Kaufman and Broad to be listed as one of the country's 200 fastest growing companies by Standard and Poor's and became the first home builder to trade on the American Stock Exchange.

In 1965, Kaufman and Broad founded the International Mortgage Company, a wholly owned subsidiary, which allowed the company to provide financing directly to its customers without involving banks or other financial institutions. In the same year that Kaufman and Broad vertically integrated into mortgage services, it consolidated production activities by ceasing operations of its contract division. Diversification into other businesses continued throughout the rest of the 1960s. In 1966, the company entered into the relatively new business of cable TV franchising with the formation of its second wholly owned subsidiary, Nation Wide Cablevision. Within five years, the subsidiary was operating franchises in 51 communities on the West Coast of the United

States. In 1969, the company founded Kaufman and Broad Home Systems, Inc., through which the company entered into the manufactured housing business. By 1971, Home Systems operated eight plants throughout the country and had sales of 9,000 units. Concurrently, in the late 1960s, Kaufman and Broad's residential housing business continued to grow. With their acquisition of the local building company Kay Homes in 1967, the company became the largest home producer in the San Francisco Bay area. Kaufman and Broad model homes were introduced in Paris, France, in 1969, two years after the company's first overseas office was opened there. Further contributing to its position as a successful company, Kaufman and Broad was recognized by President Johnson in 1967 for its commitment to participate in low-income housing programs. In that same year, the company began offering a five-year limited home warranty, the first in the industry to do so. The following year, FHA, VA, and Fannie Mae approved International Mortgage for home mortgages, making it one of only a few builder mortgage subsidiaries with that approval.

In 1968, in an effort to better define itself as a diversified corporation, the company changed its name to Kaufman and Broad, Inc. A year earlier, the company had become the largest publicly held housing corporation, its growth attributable, in large part, to happy customers. A total of 40 percent of its sales was secured through referrals from satisfied customers. In 1969, it became the first housing builder to be listed on the New York Stock Exchange.

Additional acquisitions in 1970 of Victoria Wood Development Corporation in Toronto, Canada, and in 1971 of Sun Life Insurance Company further expanded and diversified Kaufman and Broad. Following the purchase of Sun Life, the company reorganized its onsite housing activities as a new entity, Kaufman and Broad Development Group. By 1972, Kaufman and Broad was America's largest multinational housing producer and the largest single-family home builder in Paris. The company operated onsite divisions in more than five states, as well as Canada, France, and West Germany. In 1973, the company entered the pre-cut Custom Home market with plants in Denver, Colorado, and Minneapolis, Minnesota, and the high-rise condominium business with its construction project in New Jersey. Net housing revenues for 1973 had increased to $264.4 million with net income more than 9 percent of sales. As a result of high interest rates and a national recession--and the concomitant soft new home sales in 1974--the company experienced its first full year net loss. Despite the loss, Kaufman and Broad maintained its new market growth and customer service efforts strategy to assure long-term profitability. In 1975, it expanded into new markets such as Brussels, Belgium, introduced new products, and offered new services such as the industry's first ten-year homeowner warranty. By 1977, the recession had subsided and the housing market had rebounded; the company celebrated the sale of its 100,000th home, which was an industry first.

As the company entered the 1980s, its growth was again threatened by high interest rates and an industry recession. In an effort to better align its diverse business interests and to improve operations, the firm was reorganized into four operating groups: Kaufman and Broad Development Group for home building; International Mortgage Company for mortgage services; Home Systems for manufactured housing; and Sun Life for life insurance. Following the new management's long-term strategy to concentrate on select regional markets with strong growth potential and exit those markets that did not, resulted in Kaufman and Broad phasing out its divisions in Illinois, New Jersey, Germany, and Belgium by 1989. The recession of the early 1980s and the new management's corporate strategy resulted in the company exiting other markets over the next several months, and by the following year Kaufman and Broad had reduced its onsite activities to California, France, and Canada. This ultimately led to improving housing revenues by 55 percent in 1985. In addition, the corporation set company records for year-end financials in both revenue and net income. With the improved sales, the company had become the largest single-family home builder in California. The following year, Kaufman and Broad Land Company was formed to manage property purchasing. Home building in California continued to be strong, with communities such as East Hills in Anaheim, which sold 52 of the 54 homes available in the first weekend.

In 1985, the company acquired Bati-Service, an entry-level home builder in France. This purchase made Kaufman and Broad's French division the third largest builder in the country. That same year in California, the two regional offices each divided into two new divisions. The four divisions allowed the company to address the specific needs of the local community. In 1986, the corporation again reorganized. Kaufman and Broad Development spun off from Kaufman and Broad Inc. and formed Kaufman and Broad Home Corporation. All onsite housing activities, with the exception of manufactured housing, transferred to the new organization to focus on real estate development. That same year, Kaufman and Broad Home Corporation formed a new commercial development division in Paris, Kaufman and Broad Development. Within two years, this new division had completed a senior citizen apartment complex and 12 office buildings in Paris.

In 1989, the French division approved plans to build Washington Plaza, a new Paris office complex, securing $600 million from pre-sales to groups of institutional investors, a transaction that represented the largest single real estate deal in that country's history. Two new divisions were formed in Paris in 1989: Maisons Individuelles and Kaufman and Broad Renovation. The Renovation division was established to refurbish older office buildings in the downtown area. Management expanded into this new business because it felt that it provided a new growth opportunity given the scarcity of land in that area. By 1989, due in large part to the division's commercial development activities, French revenues more than quadrupled from four years prior. That same year, Kaufman and Broad Home Corporation split into two companies, each worth approximately a billion dollars: Broad Inc. (which later became SunAmerica) and Kaufman Broad Home.

In the mid-1990s, sales continued strong in the California region despite a recession, although profits fell as the company enticed buyers with free upgrades and waived down payments. The company increasingly focused on first-time buyers, reducing its higher-priced home inventory; the average price for a Kaufman and Broad new home was typically thousands of dollars below the statewide average. Moreover, its mortgage subsidiary financed more than three-quarters of the company's California home purchases by offering competitive mortgage programs designed for first-time buyers. In 1993 Kaufman and Broad opened offices in Arizona, Nevada, and Colorado. The following year, the company moved into Utah. In each area, first-time buyers were targeted. Nevertheless, the continued slow market in California and Paris hurt the company's bottom line: Profits fell by 38 percent in 1995, and by 1996 the company was showing a loss of $61 million. The next year, however, the company rebounded to profits of $58 million.

In 1998 Kaufman and Broad instituted KB2000, a new operating strategy that included greater choice for customers in the design and construction of their homes. The company began surveys of home buyers in its regions of operation, hoping to identify popular home designs and features. It incorporated those ideas into new home showrooms, which customers could walk through to help them choose features, such as lofts, porches, or types of flooring, that they wanted as part of their homes. Each regional division soon had a new home showroom.

The corporation began a new expansion strategy in 1998, one based on acquisitions rather than the opening of new offices. That year Kaufman and Broad entered the Houston market by purchasing Hallmark Residential Group, Inc., the parent company of Dover Homes and Ideal Builders. The $50 million deal gave the company access to approximately 4,700 lots in the Houston area and 90 employees. Kaufman and Broad also purchased Colorado-based PrideMark Homes for $65 million, raising the company to a dominant position in the Denver market. To round out that year's purchases, the company acquired Estes Homes for $47 million, giving Kaufman and Broad an entrée into the markets in Tucson and Phoenix, Arizona. By the end of the year, the company was enjoying net income of $95 million.

In a much larger deal the following year, Kaufman and Broad purchased Lewis Homes for approximately $409 million, plus the assumption of $135 million in debt. Lewis Homes was the nation's largest privately held home builder and dominated the markets in Las Vegas and northern Nevada. It also held significant portions of the markets in

Sacramento and southern California. Kaufman and Broad expected to combine their businesses in California, benefiting from economies of scale. The company's expansion spree and a healthy housing market helped raise the company's revenues to $3.8 billion in 1999.

In 2000 the company's French subsidiary, Kaufman and Broad, S.A., held an initial public offering of stock, although Kaufman and Broad Home Corporation continued as the majority shareholder, with approximately 50 percent ownership. The offering raised about $113 million. The French home builder had been enjoying booming sales of its apartments and single-family homes in 1999 and 2000. The subsidiary's revenues reached $195 million in fiscal 2000. The same year, Kaufman and Broad Home Corporation initiated a repurchase plan of more than half the stock the company had issued as part of its 1999 acquisition of Lewis Homes.

Kaufman and Broad introduced its Dream Home Studios in 2000, an updated and vastly expanded version of the company's new home showrooms. In addition to this facelift, the company changed its name to KB Home, a name many customers had already been using. New name or not, KB Home continued its steady improvement, reaching revenues of $3.93 billion and net income of $210 million in 2000. The following year, the company continued its expansion with the acquisition of northern Florida-based Trademark Home Builders, Inc., and recorded revenues of $4.57 billion.

Business Model

As one of the nation's premier homebuilders, KB Home (NYSE: KBH) operates in four different geographical regions which covers twelve states as well as owning a financial services arm, KB Home Mortgage Company[1]. KB Home offers a variety of homes primarily targeted towards first-time and first move-up customers, offering homes in development communities, at urban in-fill locations, and as part of mixed-use projects. The firm offers numerous proprietary product lines to differentiate from competitors and give customers flexibility in housing choices and energy sustainability options including the 'Open Series Line', 'Built to Order', and 'My Home. My Earth.' KB Home Mortgage is the integrated financial services arm which offers mortgage banking, title and insurance services to KB Home homebuyers. This operation is a joint venture with Countrywide, a subsidiary of Bank of America. In the fiscal year of 2009, KB Home delivered 8,488 homes at an average price of $207,100 and earned a revenue stream of $1.82 billion. Homebuilding operations accounted for 99.5% of the total revenue while the financial services segment brought in the remaining .5%.

Community Development & Land Inventory Management

KB Home uses a four step process with the design of every home: land acquisition, land development, home construction, and sale. These four phases usually take 6 to 24 months from the beginning to the final product, with progress depending on required government approvals, size of the community, on-site preparation activities, weather conditions, and marketing results. On average, communities are comprised of 50 to 250 lots which range in size from 1,000 to 13,500 square feet. Homebuyers have a choice of 3 to 15 home designs to choose from, with a wide array of customization options in each home design[1].

KB Home seeks to acquire land consistent with its business model of spaces with fewer than 250 lots with entitlement for residential construction. Often, KB Home will take advantage of areas that have been physically developed, to save capital costs and expedite the building process. KB Home uses in-house and third party research to determine potential land areas for acquisition consistent with the KB Home business model. Many of these considerations include consumer preferences, general economic conditions, specific market conditions, comparable prices of new and resale homes in the market, expected sales rates, proximity to metropolitan areas and employment centers, population and commercial growth patterns, estimated costs of completing lot development, and environmental concerns. If market conditions or KB Home strategy changes in a given area, KB Home resells land to generate cash.

After the purchase or development of land, KB Home begins marketing and constructing a few model homes for potential buyers to view. KB Home acts as the general contractor on the houses and hires experienced subcontractors compliant with KB Home standards for some production activities. KB Home seeks to employ mass production techniques and pre-fabricated, standardized components and materials to help expedite the on-site production of the homes in a given community. The homes are sold under standard purchase contracts, requiring a customer deposit and containing all the terms of agreement within the sale. KB Home sales personnel help sell the homes, and receive commission on top of their salary for units sold.

Customer Financing

Homebuyers from KB Home can use mortgage financing they receive from any qualified lender. KB Home offers on-site mortgage financing for prospective buyers with the KB Home Mortgage subsidiary. The mortgage arm offers numerous financing options for customers and helps complete the on-site sale process, making KB Home a “one-stop shop” for homebuyers. KB Home mortgage was responsible for 84% of the total loans KB Home customers who needed financing received[1].

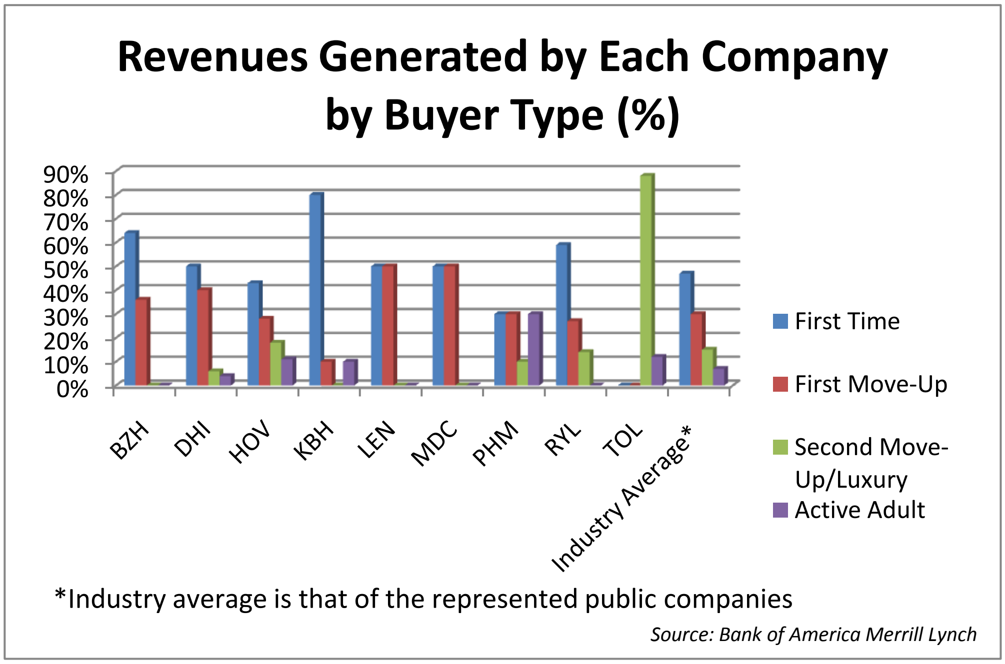
Competitive Analysis

Overview

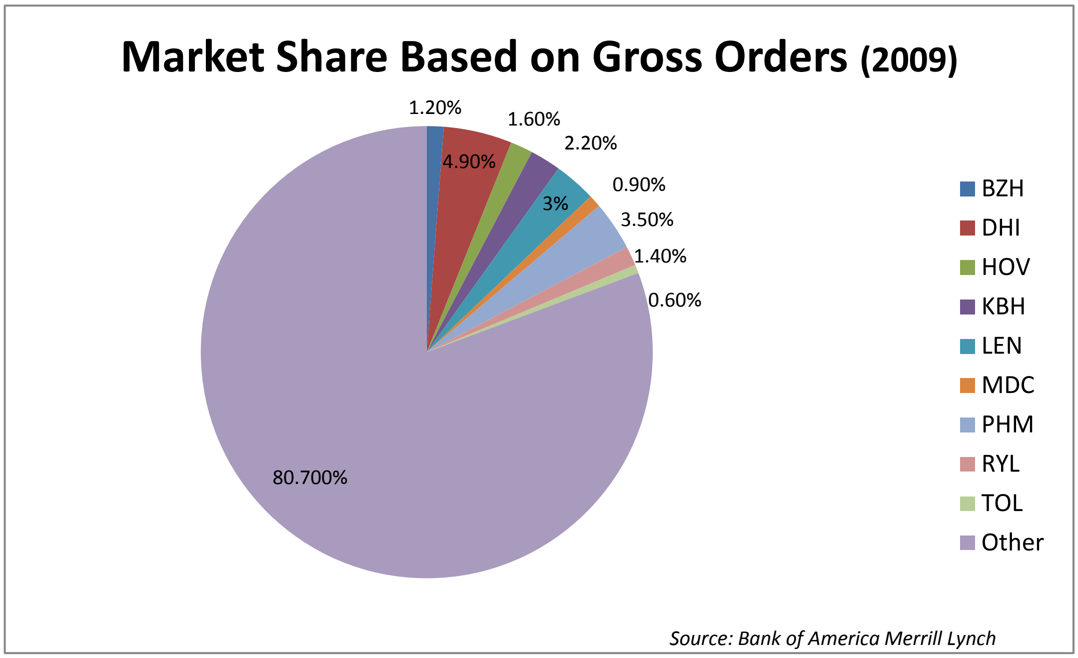
Force	Threat Level
Internal Rivalry	****
Entry/Exit	***
Substitutes	****
Complements	**
Buyer Power	*****
Seller Power	*
*Scale based from * (low) to ***** (high)*	

Internal Rivalry

KB Home is one of many competitors in the homebuilding industry, classified under SIC Code 1531 (Operative Builders)[3]. The more specific niche that KB Home operates in within the industry is first-time and first move-up buyers. Though the homebuilding industry is saturated with thousands of homebuilders with different areas of scope and strategy, the publicly traded companies that most resemble the positioning of KB Home are Beazer Homes (BZH),D.R. Horton (DHI),Lennar Corporation (LEN), Ryland Group (RYL), and M.D.C. Holdings (MDC). Other companies in the industry that share a small overlap with KB Homes are Hovnanian Enterprises (HOV), Pulte Group (PHM), and Toll Brothers (TOL). This is best illustrated in the graph below:



The graph conveys that the largest amount of overlap with KB Home in terms of penetration into First Time and First Move-Up markets comes from BZH, LEN, MDC, and RYL. As KB Home has micro-targeted the first-time buyer more than any other publicly traded company, KB Home should be well positioned relative to its rivals given the fact that analysts believe that homebuilders will see outperformance from the first-time buyer as opposed to other buyers. On the other hand, rivalry is expected to increase in this space given the push by analysts for competitors to target these consumers and the amount of government stimulus in the housing market geared towards this demographic[4]. It is also important to acknowledge that many privately held companies operate in this space and fiercely compete for market share. Please see the graph below for more details:



The graph shows that over 80% of the industry is devised by private homebuilders. Public homebuilders have a disproportionately large share of the market given they comprise just a few of several hundreds of homebuilder companies. KB Home comprises 2.2% of the total market share in the United States homebuilding industry by gross orders of 2009. Though internal rivalry is extremely high, the housing crisis helped position many public companies to gain market share once profitability returns as 2007-2009 brought about several hundreds of bankruptcies from privately held companies. The industry has become much more consolidated with the associated bankruptcies of privately owned companies with the current housing crisis and as a result the more dominant players in the industries have been the beneficiaries of increased opportunities as competition has dropped. This outcome has led KB Home to expect a return to profitability in 2011. The consolidation within the industry could pay huge dividends for KB Home and other publicly traded companies that continue to stay well positioned.

Despite the company's favorable position relative to the rest of the market, the excess inventories of foreclosed homes have stemmed a new force of rivalry in the industry. The inventory of foreclosed homes is currently around 9-10 months of home sales while previous historic levels have been a few months lower. However, most banks, including Bank of America and Citi, have taken huge measures to prevent further increases in foreclosed houses which would ultimately create less disruption and saturation in the housing market[5].

To better compete with rivals and create product differentiation, KB Home introduced the 'Open Series' Line to increase affordability and customization for new home buyers. KB Home cites that the 'Open Series' gives homebuyers better choices on design on elements such as flooring and countertops while giving them input on the layout of the floorplan. Compliant with Energy Star guidelines, the homes are extremely energy efficient (as much as 45% more efficient than houses built a decade ago). The line is backed by KB Home's 10 year warranty and has been expanded to all of the regions in which KB Home operates[1]. This well received initiative better positions for KB Home in this extremely tough market.

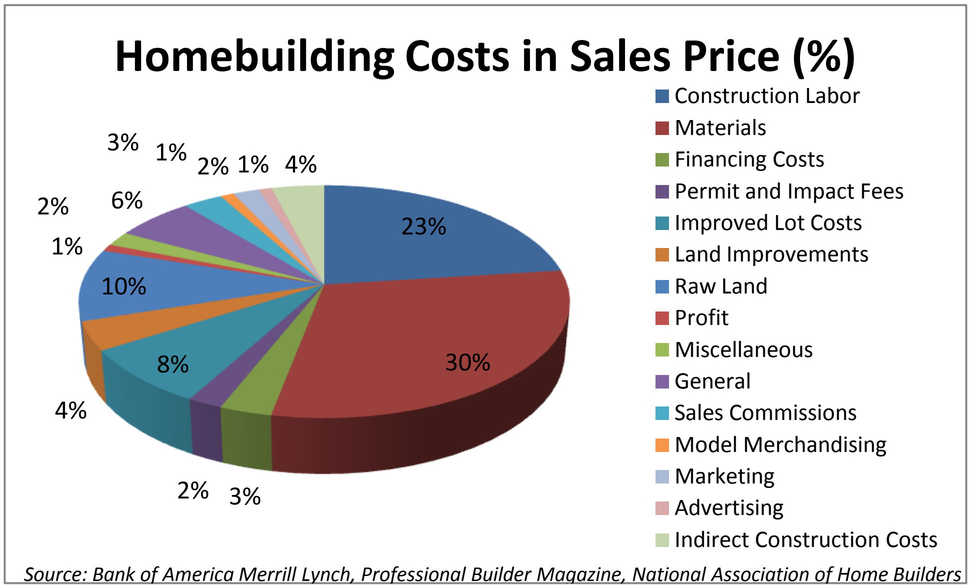
Entry/Exit

Entry- Financing

The homebuilding industry is a rather capital intensive industry relative to most other industries. One indication of this is the high debt to equity ratio of the homebuilding industry ratio (3.5), which often characterizes an industry as one that requires more capital[6]. The ability to raise adequate capital to be competitive in this industry stands as a barrier since many inputs go into the final sale price of the house.

This is much different than industries with smaller barriers to entry from a capital point of view, such as the technology industry (.8). Ultimately, the ability to raise the capital necessary to be competitive can hinder the ability to enter this industry. Further, the ample amount of capital needed may force higher costs of borrowing on new entrants, making it difficult in the future to meet obligations from creditors.

To better understand the aspects that could create difficulty for new entrants, it is critical to acknowledge the different inputs and scale of costs that go into a house. According to the Professional Builder Magazine and National Association of Home Builders, below are the inputs and percentage of costs relative to the sales price:



Entry- Economies of Scale

Clearly, economies of scale are extremely helpful for homebuilders in many of the inputs. A larger and more developed firm could save costs in numerous ways, including model merchandising, materials, raw land, and construction labor. Model merchandising, or designing specific track homes for lots, allows the model homes designed to be used over a variety of areas, ultimately reducing the total cost of each modeled home for more houses built within that specification. Also, the costs of model merchandising would also give customers more options for model homes which would ultimately yield a premium for the optionality of different track homes or different features within the homes. KB Home has experienced this economy of scale with the 'Open Series' Line that has recently expanded nationally to offer customers more customization and affordability options. Since the models and options that each buyer has are available in across all regions, the cost per unit of the model merchandising would be substantially smaller than less developed homebuilders with fewer homes to sell or stationed in less territory.

Further, the opportunity to buy in bulk or have flexibility with different inputs is extremely advantageous to established homebuilders such as KB Home. Inputs such as raw land and materials could be bought in bulk from suppliers, ultimately suppressing the expense of these average variable costs. The transferability of construction labor is also extremely beneficial. KB Home is able to transfer construction between different locations and housing models so there is a good level of mobility and constant work needed with this input[1]. The inability to adapt some of these economies of scales would ultimately bring complications with new entrants in being cost competitive with more established players in the homebuilding industry.

Entry- First Mover Advantage

First mover advantage creates difficulty for new companies attempting to enter the homebuilding industry, primarily with respect to land developments and advertising. In terms of land developments, many characteristics contribute to the valuation of a property of land which tends to be centered on the location. Developed firms acquire land much before developing on it, as the years of land supply is a common metric in the homebuilding industry. Thus, new entrants may have difficulty acquiring "desirable" land allotments from the perspective of a consumer, or may run into a shortage of available land to build on in a given area which would ultimately hurt the prospects of a new developer. Advertising also yields better results to industry veterans as the goodwill and reputation of the firm is more established in the industry which makes consumers gravitate towards trusting their product offering. New entrants would have to make substantial expenses towards advertising to convince consumers to choose their products over a previously established company.

Entry-Barriers to Entry

A true barrier to entry in the homebuilding industry is the inaccessibility to procure required land or building permits. Without the proper permits, a firm will not be able to legally enter into the industry. Regardless of most of the other areas related to entry in the homebuilding, this is necessary for the opportunity to be a competitor in the industry.

Entry- Vertical integration

More established firms in the industry contain a financial services arm that deals with mortgages. These subsidiaries help give financing to customers who purchase houses through the company. The vertical integration of the lending arm to the main business of home building helps make established companies a "one-stop shop" for consumers. KB Home has adopted this form of vertical integration with its KB Home Mortgage Company subsidiary. New entrants may find it difficult to compete with established firms that have integrated other subsidiaries into the business model.

Exit- Liquidity Constraints and Market Saturation

An exit in this industry would be very difficult in terms of market liquidity and obtaining anything near a "fair value" price for the total inventory with regards to all input costs. Inventory liquidation would result in very compressed margins given that the market is currently highly satured in terms of monthly inventory on both new and foreclosed homes. Given the recent bankruptcies of over 100 companies since 2007, any inventory, raw materials, or other input would most likely be in very high supply and relatively illiquid[7].

Exit- M&A Consideration

Firms looking to exit the industry could also consider M&A activity to create some level of synergy between two firms. Though the firm looking to exit may lack bargaining power or any leverage in the negotiation, unless being courted by multiple firms, this result would most likely be advantageous as takeover firms may view such a firm as synergy in terms of management, inputs, location, or tax purposes. This would most likely be preferable to a complete liquidation, especially in today's market where many of the comparable inventory and other inputs would be sold in oversaturated markets.

Substitutes

The level of substitution for consumers is high as other homebuilders, rental properties, and foreclosed homes are other suitable housing options in the demographic that KB Home primarily targets. As previously discussed in the internal rivalry analysis, the homebuilding industry is extremely competitive and numerous other public homebuilders overlap with KB Home in the buyer of houses. Further, though specific information is not available, private homebuilders play a significant role in the entire homebuilding industry. In line with analyst recommendations, many homebuilders have recently focused more on the first-time buyer which has historically been KB Home's target demographic. As firms continue to reach out in this segment of the industry, more substitutes can continue to threaten the business of KB Home.

Though government stimulus and initiatives have been geared for first-time buyers via tax credits, both difficulties in the availability of credit at desirable rates and low consumer confidence have influenced consumers to rent as opposed to buy homes. Although mortgage rates are the lowest since 1972, many potential homebuyers continue to struggle to access credit at a desirable rate, if at all. Ultimately, this would prevent potential consumers to finding renting more attractive. Moreover, with a continued high rate of unemployment and uncertain economic conditions, potential buyers may continue to fear that conditions could get worse or other asset prices could fall, steering them away from purchasing a house right now. Many would prefer to make the decision to purchase presumably their most expensive asset in a time when their future outlook is much more certain and economic conditions stabilize.

Last, foreclosures continue to be one of the biggest drags in terms of substitutes in the homebuilding industry. The foreclosed home inventory consists of 9-10 months of home sales which is a few months over the historical average[4]. The excess inventory has substantially depressed prices, providing many first-time buyers and other customers a cheaper substitute than a brand new home. Further, many banks have repossessed these houses from mortgage defaults with the intention of liquidating quickly to raise cash. Nevada, Arizona, California, and Florida have experienced the highest rates of foreclosed homes which directly compete with many of the larger areas of KB Home's business line.

Complements

The mortgage market is an enormous complement to homebuilders. The mortgage market allows homebuyers to finance the purchase of a home in several different forms as opposed to buying the house in cash. The loan is then securitized and sold on a primary market to a creditor. The creditor can sell the securitized mortgage on the secondary market where mortgage backed securities trade between investors. The rates of the mortgage are determined by the secondary market. The current low interest rate environment has significantly helped KB Home and other homebuilders as low interest rates increase the affordability of houses since buyers assume a lower interest rate on the mortgage.

The government sponsored entities, the Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) helps increase the money supply available for mortgage lending and increases the amount of money accessible to new home purchases. Commonly referred to as Fannie Mae and Freddie Mac, these two corporations help to stimulate the housing market by making money more accessible for borrowers to receive credit as well as increase liquidity in the secondary market[8,9]. These agencies are complimentary to the housing market as they substantially help spur demand for housing in the United States.

Government stimulus in the form of fiscal and monetary expansion has also well-complemented home builders. The government has stimulated the housing market in numerous ways to increase housing demand: low real interest rates, the mortgage buyback program, and tax incentives for first-time buyers. The Fed setting low real interest rates has effectively helped mortgage rates come down as mortgages are priced on a spread over the United States Treasury bonds. As yields have come down with the near-zero interest rate policy the Fed has implemented, the interest on mortgages has come down for new buyers and has allowed outstanding mortgage owners to refinance their mortgage to make terms more affordable. Further, the Fed has participated in a $1.25 billion mortgage buyback program where the Fed has purchased $1.25 billion of mortgages on the open market to keep mortgage rates low. This program discontinued on March 31, 2010 as the Fed believes that enough private interest in the mortgage market remains to keep mortgages low[10]. Finally, the government has passed legislation for new home buyers to access an $8,000 tax credit to encourage demand in this demographic[11]. This has significantly helped KB Home and other homebuilders targeting the first time home buyer.

Buyer Power

Given the current high inventory levels and tight competition between homebuilders, the bargaining power is primarily in the hands of the buyer. Homebuilders have been forced to sell houses at lower profit margins and less volume as competition between other homebuilders, rental properties, and foreclosed houses are extremely high. Homebuilders have been taking losses in the short run and trying to generate cash to meet obligations to be sustainable in the long run when the economy recovers. Homebuilders will regain some of their bargaining power as the industry recovers over the next year and a half according to analysts, and as the industry continues to consolidate[5].

KB Home is mixed in terms of buying power relative to its competitor. Given its heavy portfolio exposure to California, Arizona, Nevada, and Florida, these markets are extremely saturated with inventory at depressed prices which may further reduce bargaining power relative to competitors positioned in areas with a more stable housing market. However, KB Home has a “short land” position at 4.3 years compared to the industry average of 6.4 years, meaning they have less land to develop which gives it more flexibility and liquidity in its operations[4].

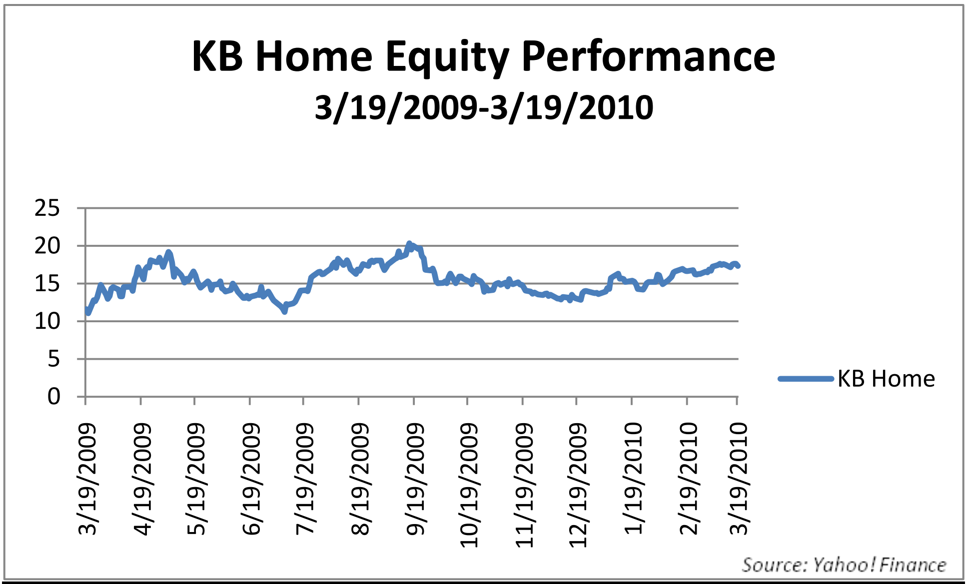
Supplier Power

KB Home has a favorable position with its suppliers of raw materials. KB Home has a centralized regional purchasing plan that allows for large quantity purchase discounts and is often eligible for manufacturer and supplier rebates[1]. This allows KB Home to achieve the most favorable prices from suppliers and manufacturers. Supplier power is of little concern to KB Home as KB Home receives discounts and competitive pricing which ultimately allows the firm to save much money through its economies of scale.

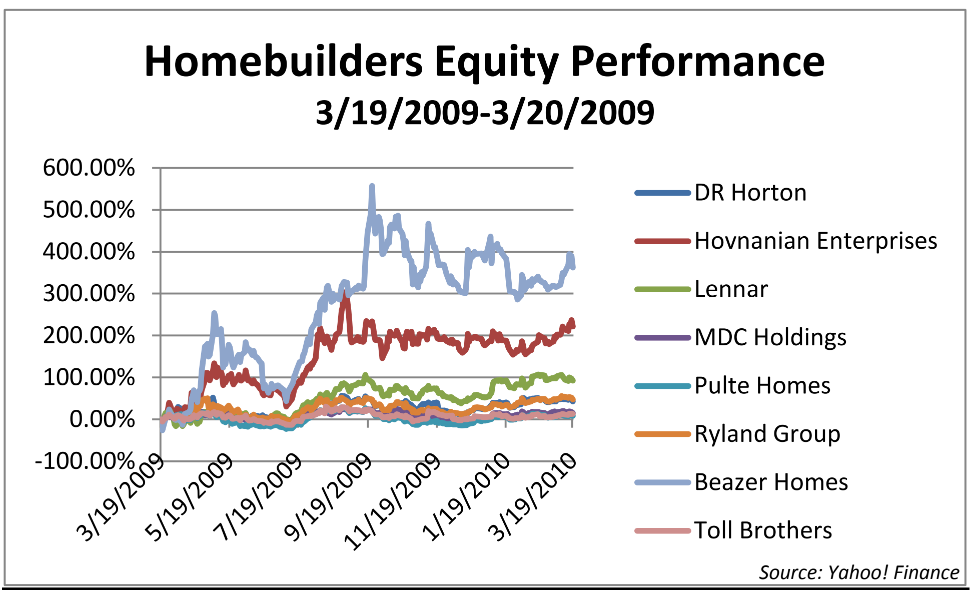
Financial Analysis

Stock Performance & Indicators

KB Home Equity Performance (3/19/2009-3/19/2010)



Homebuilders Equity Performance (3/19/2009-3/19/2010)



Key Statistics (3/19/2009)-(3/19/2010):

Company	KB Home	DR Horton	Hovnanian Enterprises	Lennar	MDC Holdings	Pulte Homes	Ryland Group	Beazer Homes	Toll Brothers
1 Year Return	49.40%	42.97%	221.58%	92.24%	15.49%	8.42%	46.96%	362.38%	13.11%
Market Cap. ($ Millions)	1,650	4,107	300	3,206	1,656	4,469	11,019	172	3,273
52 Week High	$20.34	$13.70	$5.61	$17.34	$38.07	$13.32	$24.89	$6.64	$23.42
52 Week Low	$11.08	$8.25	$1.18	$7.01	$26.59	$7.92	$14.50	$0.75	$15.55
								Source: Yahoo! Finance	

KB Home Attribution Analysis

Direction towards an economic and housing recovery has propelled KB Home to sizable gains over the past year. Though positive earnings are out of sight in the near future, investors feel confident about the long term prospects and positioning of KB Home given the sizable returns with continued negative earnings as well as its ability to meet debt obligations in this time horizon. KB Home has performed similarly to a few of its peers such as Ryland Group and DR Horton, while a few of the smaller cap homebuilders such as Beazer Homes and Hovnanian Enterprises have generated excess returns relative to the group, most likely because of bankruptcy concerns earlier in 2009. KB Home's smaller exposure to land supply helps offer KB Home more flexibility in future planning and more liquidity. Another encouraging signal attractive to investors is in the fourth quarter of 2009, the average sales price per unit is the second lowest at $203,000 while KB Home has some of the highest gross margins, which demonstrates their ability to be cost competitive without sacrificing margins[7]. Beyond systemic risk in the homebuilding sector, a concern that continues to drag on KB Home is the SEC filing that currently lacks.

KB Home Options Indicators

KB Home Put/Call Ratio			
Month/Year of Expiration	Call Volume	Put Volume	Put/Call Ratio
Mar-10	149	78	0.5235
Apr-10	1313	435	0.3313
May-10	44	419	9.5227
Oct-10	110	34	0.3091
Jan-11	458	65	0.1419
Jan-12	40	28	0.7000
Total	**2114**	**1059**	**0.5009**
			Source: Yahoo! Finance

The investment community is consistent with the analyst sentiment below based on the options volume on March 19, 2008[12]. A put/call ratio below indicates that investors are bullish on the stock because a higher volume of calls, or the option to buy shares of stock at a specified time in the future, than puts, or the option to sell shares of stock at a specified time in the future. Though options are often used to hedge risk or on a market-neutral trade, both of these instances would undermine the interpretation of the ratio, the put/call ratio helps give a forward looking indicator on how traders believe the stock will perform at specific times in the future. The put/call ratio indicates a bullish outlook on KB Home for every expiration time with the exception of May 2010, thus conveying that on the whole investors believe that KB Home stock will rise in the future. Given that KB Home's negative earnings and the fact that this is not expected to change until late 2010 or early 2011, the options chain indicates that the equity should rise concurrently with better earnings prospects.

Valuation Metrics

KB Home Valuation Metrics			
	KB Home	Industry	S&P 500
Price/Book	2.2	1.8	2.3
Price/Sales	0.7	0.9	1.3
Price/Cash Flow	3.6	6.2	7.3
Dividend Yield (%)	1.5	0.3	1.8
Source: Morningstar			

The Price-to-Book ratio, the price of the stock divided by the book value of common equity per share, indicates that KB Home is "over-valued" relative to the rest of the homebuilding industry. KB Home may appear to be more of a growth stock while homebuilders trading at a lower Price/Book than the industry average would be identified as a value investment. The Price-to-Sales ratio is the price of the stock divided by the sales per share. The lower than average price-to-sales ratio of KB Home implies that less sales are made than many of its competitors on a per share basis. Unless lower sales are for negative reasons, this could present growth opportunities for KB Home in the future to generate more sales and gain market share. The Price-to-Cash Flow ratio is a three-year average of the stock price over the cash flow per share over the trailing 12 months. KB Home's competitors have had better ability to generate a constant stream of cash over this time, a key quality indicative of financial health of the company. However, the higher dividend yield signals financial strength with cash available to pay a higher dividend than competitors. It is important to acknowledge that dividends can also indicate that growth opportunities for the firm are non-existent so cash is given back to investors rather than invested elsewhere by the firm at a higher rate of return.

Liquidity & Financial Health

KB Home: Liquidity Measurements	
Current Ratio	1.15
Quick Ratio	0.56
	Source: Morningstar

The current ratio indicates that KB Home is relatively liquid, given that this ratio of current assets to current liabilities is over 1 which is usually indicative of a liquid company. However, the quick ratio is rather low at .56 which suggests that in the event of liquidation there would be an extreme amount of difficulty in turning over inventory, given that this ratio of cash and cash equivalents and marketable securities over current liabilities is less than 1. It shows how much of the current assets of KB Home are in inventory. It is important to acknowledge that lower quick ratios may be expected in the homebuilding industry due to the longer cycles of inventory turnover.

Analyst Sentiment:

On the whole, although more bullish than bearish, analysts tend to have a neutral outlook on KB Home. A compilation of recommendations across the street give 5 buy ratings, 9 neutral ratings, and 2 sell ratings4. Analysts like the long-term prospects of KB Home, though cite that the firm will not be profitable until 2011[7]. KB Home is relatively well positioned given that they have much less land exposure than other homebuilders, have been preserving higher profit margins than competitors, and have had a strong focus on first time home buyers. Further, KB Home is positioned for upside with possible addition of more tax credits and other stimulus to the housing market. However, given that their competitors are forecasted to deliver positive earnings and the current SEC investigation on KB Home that lacks transparency could bring unforeseen risks to the earnings and reputation of the firm, KB Home clearly has a few factors weighing down on its performance[13]. A few of the analysts who cover KB Home are quoted below:

Analyst Sentiment- Bullish

“While we are not excited about the company’s exposure to Las Vegas we believe that potential for a California housing stimulus package is a counterbalancing factor for this low-end builder.”- Goldman Sachs

“We have contended for over a year that the first time homebuyer is the best strata of the new home market at this point in the cycle. Following three years of home price declines it is easier for a renter to become a new homeowner than for current owners to sell their homes ahead of purchasing another house.”- Goldman Sachs

"KBH is addressing foreclosures and resales through its 'Open Series' product line, which is geared toward offering lower priced home while preserving margins."- Bank of America Merrill Lynch

"First-time buyers should boost volumes while asset light strategy in conjunction with finished lot purchases will mitigate the risk of impairments."- Bank of America Merrill Lynch

Analyst Sentiment- Bearish

"KB home will not be profitable in 2010. In a year where half of our coverage will be profitable we believe that alpha generation as investors "Buy the Profits." Builders that will not be profitable should trade at a discount to the average."- Goldman Sachs

"Until the investigation is closed management's focus on the issue in addition to the added regulatory costs are negative for the company."-Goldman Sachs

"We rate KBH as High Risk because of the uncertainty surrounding the ultimate duration and magnitude of the housing market's downturn."- Citi

"It is not as geographically diverse as some of the other large homebuilders and has greater relative exposure to some of the country's more troubled markets such as Arizona, California, and Nevada."-Citi

Industry Performance

Conditions in the housing started to show signs of stabilization towards the end of 2009. The Bureau of Economic Analysis cites that the US economy grew 5.7% in the fourth quarter based on a seasonally adjusted annual rate (SAAR) while the economy expanded 2.2% in the previous quarter[14]. Consistent with US economic growth, the housing component matched growth at 5.7% in the fourth quarter, though significantly outperformed in the third quarter of 2009 marking an 18.9% growth increase. However, on annualized basis, the housing component of GDP contributed to a .65% decrease to real GDP growth in 2009. This was an improvement over the 1% drop to real GDP growth in 2008. Please read below for several highlights in the US Housing Market:

* Although housing construction starts decreased in the fourth quarter of 2009 (most likely because of poor weather), both single-family housing permits and completions increased in this time period.

* The Federal Housing Finance Agency (FHFA) purchase only index estimated an increase in prices by .2% in the third quarter of 2009, marking the first price increase in this index since the second quarter of 2007.

* The National Association of Realtors (NAR) reported that the median price of new homes in the fourth quarter of 2009 was $214,700, which was very close to the previous quarter and 4% less than the fourth quarter of 2008. The mean house sold for $270,500.

* The median price of existing homes sold was $173,500 in the fourth quarter of 2009, according to the NAR. This is three percent less than the third quarter of 2009 and eight percent lower than the fourth quarter of 2008. The average price of $218,200 was also lower than both of these quarters.

* Inventory levels of new homes in the fourth quarter would support approximately 7.5 months of sales, nearly the same as the third quarter of 2009 and lower by 3.6 months than the final quarter of 2008. The average inventory during this time period was 236,000 homes, down a significant amount from previous quarters.

* Inventory levels of existing homes in the fourth quarter would support near 7 months of sales, down two months from the third quarter of 2009 and less than 3.3 months than the final quarter of 2008. As for previously existing homes, it is important to acknowledge that further delinquencies and foreclosures, known as the 'shadow inventory,' could continue to saturate the market and adversely weigh on prices.

* The NAHB/Wells Fargo composite Housing Market Index was at 17 in the fourth quarter of 2009, slightly down from the previous quarter but up from 11 at the end of 2008. The index is comprised of current market activity, future sales expectations, and prospective buyer traffic.

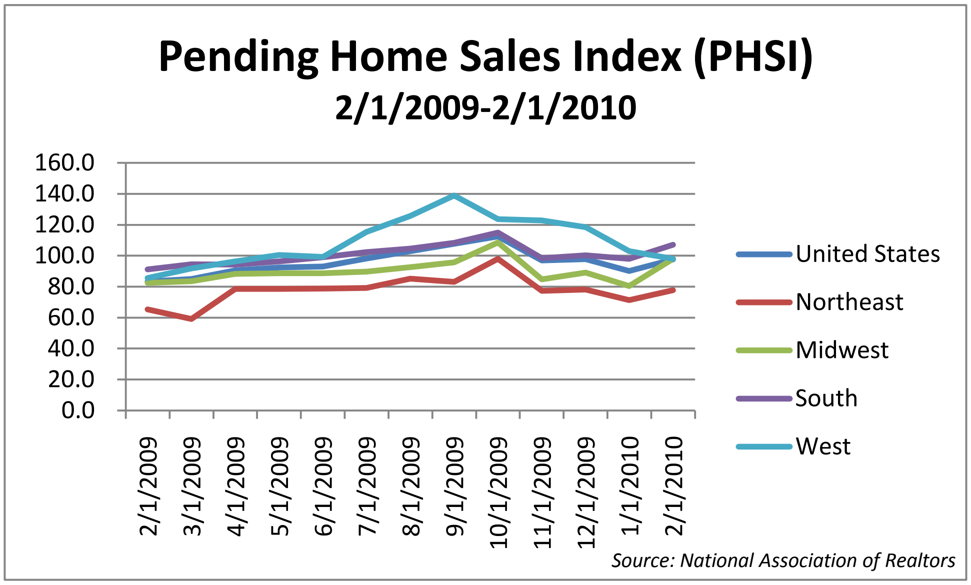
* The NAR Housing Affordability index rose, as median prices of existing single-family homes dropped 3% and mortgage rates fell 24bps.

* The national homeownership rate was 67.2% in the fourth quarter of 2009, which fell 40bps from 67.6% in the third quarter of 2009. The homeownership rate in the fourth quarter of 2008 was at 67.5%.

* The average interest rate for 30 year, fixed-rate mortgages in 2009 was 5.04%, according to Freddie Mac's Primary Mortgage market Survey. This marks an all-time low annual average rate and was 99bps lower than the annual average of 2008.

* The FHA guaranteed 2.023 million mortgages in 2009, a 38% increase relative to the 1.468 million mortgages guaranteed in 2008.

Pending Home Sales Index



The National Association of Realtors (NAR) Pending Home Sales Index is one of the leading indicators in the housing market[15]. The index tracks home sales that have not yet closed, although a contract has been signed. The PHSI helps indicate future existing home sales since it takes a few weeks for the deal to close after the contract has been signed. Further, the PHSI has implications on economic conditions and consumer spending, given that a house is typically the largest asset a person owns, it can be a good gauge for increases in income and confidence in the economy.

The graph above shows the index from 1/1/2009 through 1/1/2010. On a year over year basis, the index has slightly improved on the whole both domestically and regionally. Stimulus packages over the course of the year have fueled some improvement, as indicated by several upward spikes in the index in the later part of the year. It appears now that some of the volatility has calmed down and the index is slowly stabilizing in most areas.

Statement of Operations

KB Home Consolidated Statements of Operations (In Thousands, Except Per Share Amounts)			
	Year Ended November 30,		
	2009	2008	2007
Total Revenues	$1,824,850.00	$3,033,936.00	$6,416,526.00
Homebuilding:			
Revenues	$1,816,415.00	$3,023,169.00	$6,400,591.00
Construction and land costs	-$1,749,911.00	-$3,314,815.00	-$6,826,379.00
Selling, general and administrative expenses	-$303,024.00	-$501,027.00	-$824,621.00
Goodwill impairment	---	-$67,970.00	-$107,926.00
Operating income (loss)	-$236,520.00	-$860,643.00	-$1,358,335.00
Interest Income	$7,515.00	$34,610.00	$28,636.00
Loss on early redemption/interest expense, net of amounts capitalized	-$51,763.00	-$12,966.00	-$12,990.00
Equity in loss of unconsolidated joint ventures	-$49,615.00	-$152,750.00	-$151,917.00
Homebuilding pretax income (loss)	-$330,383.00	-$991,749.00	-$1,494,606.00
Financial Services:			
Revenues	$8,435.00	$10,767.00	$15,935.00
Expenses	-$3,251.00	-$4,489.00	-$4,796.00
Equity in income of unconsolidated joint venture	$14,015.00	$17,540.00	$22,697.00
Financial services pretax income	$19,199.00	$23,818.00	$33,836.00
Income (loss) from continuing operations before income taxes	-$311,184.00	-$967,931.00	-$1,460,770.00
Incomes tax benefit (expense)	$209,400.00	-$8,200.00	$46,000.00
Income (loss) from continuing operations	-$101,784.00	-$976,131.00	-$1,414,770.00
Income from discontinued operations, net of income taxes	---	---	$47,252.00
Gain on sale of discontinued operations, net of income taxes	---	---	$438,104.00
Net Income (loss)	-$101,784.00	-$976,131.00	-$929,414.00
Basic and Diluted earnings (loss) per share:			
Continuing operations	-$1.33	-$12.59	-$18.33
Discontinued operations	---	---	$6.29
Basic earnings (loss) per share	-$1.33	-$12.59	-$12.04
			Source: KB Home 10-K

KB Home produced total revenues of $1.82 billion for the fiscal year of 2009 while posting a loss of $101 million in this period. The total revenues fell significantly from the previous few years, as the 2009 revenue was less than one-third of the revenue stream for 2009. However, KB Home coped well with the poor business conditions with a rather small net loss relative to the previous years. The biggest losses over the past few years were realized from construction and land costs as KB Home had to take losses with asset and land sales to remain well capitalized. KB Home Mortgage Company, the financial services arm, remained profitable throughout the past few years. Earnings per share remained negative over this three year time horizon.

Balance Sheet

KB Home Consolidated Balance Sheet (In Thousands, Except Per Share Amounts)			
	Year Ended November 30,		
	2009	2008	2007
Assets			
Homebuilding:			
Cash and cash equivalents	$1,174,715.00	$1,135,399.00	$1,325,255.00
Restricted cash	$114,292.00	$115,404.00	---
Receivables	$337,930.00	$357,719.00	$295,739.00
Inventories	$1,501,394.00	$2,106,716.00	$3,312,420.00
Investments in unconsolidated joint vent	$119,668.00	$177,649.00	$297,010.00
Deferred income taxes	---	$1,152.00	$222,458.00
Goodwill	---	---	$67,970.00
Other assets	$154,566.00	$98,109.00	$140,712.00
	$3,435,989.00	$3,992,148.00	$5,661,564.00
Financial Services:	$33,424.00	$52,152.00	$44,392.00
Total assets	$3,402,565.00	$4,044,300.00	$5,705,956.00
Liabilities and shareholder equity			
Homebuilding:			
Accounts payable	$340,977.00	$521,294.00	$699,851.00
Accrued expenses and other liabilities	$560,368.00	$721,397.00	$975,828.00
Mortgages and notes payable	$1,820,370.00	$1,941,537.00	$2,161,794.00
	$2,721,715.00	$3,204,228.00	$3,837,473.00
Financial Services:	$7,050.00	$9,467.00	$17,796.00
Stockholders' Equity			
Preferred stock	---	---	---
Common stock	$115,120.00	$115,120.00	$114,976.00
Paid-in capital	$860,772.00	$865,123.00	$851,628.00
Retained earnings	$806,443.00	$927,324.00	$1,968,881.00
Accumulated other comprehensive loss	-$22,244.00	-$17,402.00	-$22,923.00
Grantor stock ownership trust	-$122,017.00	-$129,326.00	-$132,608.00
Treasury stock	$930,850.00	-$930,234.00	-$929,267.00
Total stockholders' equity	$707,224.00	$830,605.00	$1,850,687.00
Total liabilities and stockholders' equity	$3,435,989.00	$4,044,300.00	$5,705,956.00
			Source: KB Home 10-K

Although KB Home's balance sheet has been shrinking over the past few years, KB Home has clearly taken strong initiative to stay well capitalized and liquid by maintaining adequate cash reserves. The cash and cash equivalents for the fiscal year of 2009 is $1.17 billion, slightly up from the 2008 levels. As a result, the inventory of KB Home has immensely contracted due to asset and land sales that have raised cash levels to strengthen the balance sheet.

Statement of Cash Flows

KB Home Consolidated Balance Statements of Cash Flows (In Thousands)			
	Year Ended November 30,		
	2009	2008	2007
Cash Flows from operating activities			
Net Income (Loss)	-$101,784.00	-$976,131.00	-$929,414.00
Income from discontinued operations, net of income taxes	---	---	-$47,252.00
Gain on sale of discontinued operations, net of income taxes	---	---	-$438,104.00
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Equity in loss of unconsolidated joint ventures	$35,600.00	$135,210.00	$129,220.00
Distributions of earnings from unconsolidated joint ventures	$7,662.00	$22,183.00	$42,356.00
Gain on sale of investment in unconsolidated joint venture	---	---	---
Amortization of discounts and issuance costs	$1,586.00	$2,062.00	$2,478.00
Depreciation and amortization	$5,235.00	$9,317.00	$17,274.00
Loss on early redemption of debt	$976.00	$10,388.00	$12,990.00
Deferred income taxes	---	$221,306.00	$208,348.00
Tax benefit associated with exercise of stock options	$4,093.00	$2,097.00	-$882.00
Stock-based compensations expense	$3,977.00	$5,018.00	$9,354.00
Inventory impairments and land option contract abandonments	$168,149.00	$606,791.00	$1,253,982.00
Goodwill impairment	---	$67,970.00	$107,926.00
Changes in assets and liabilities			
Receivables	$35,667.00	-$60,565.00	-$71,406.00
Inventories	$433,075.00	$545,850.00	$779,875.00
Accounts payable, accrued expenses and other liabilities	-$252,620.00	-$282,781.00	-$340,630.00
Other, net	$8,296.00	$32,607.00	$13,387.00
Net cash provided by operating activities-- continuing operations	$349,912.00	$341,322.00	$1,046,899.00
Net cash provided by operating activities--discontinued operations	---	---	$297,397.00
Net cash provided by operating activities	$349,912.00	$341,322.00	$1,046,899.00
Cash flows from investing activities:			
Sale of discontinued operations, net of cash divested	---	---	$739,764.00
Sale of investment in unconsolidated joint venture	---	---	---
Change in restricted cash	---	---	---
Investments in unconsolidated joint ventures	-$19,922.00	-$59,625.00	-$85,188.00
Sales (purchases) of property and equiptment, net	-$1,375.00	$7,073.00	$685.00
Other, net	---	---	---
Net cash provided (used) by investing activities--continuing operations	-$21,297.00	-$52,552.00	$643,149.00
Net cash used by investing activies--discontinued operations	---	---	-$12,112.00
Net cash provided (used) by investing activities	-$21,297.00	-$52,552.00	$643,149.00
Cash flows form financing activities:			
Change in restricted cash	$1,112.00	-$115,404.00	---
Proceed from (redemption of) term loan	---	---	-$400,000.00
Proceeds from issuance of senior notes	$259,737.00	---	---
Payment of senior notes issuance costs	-$4,294.00	---	---
Repayment of senior and senior subordinated notes	-$453,105.00	-$305,814.00	-$258,968.00
Payments on mortgages, land contracts and other loans	-$78,983.00	-$12,800.00	-$114,119.00
Issuance of common stock under employee stock plans	$3,074.00	$6,958.00	$12,310.00
Excess tax benefit associated with exercise of stock options	---	---	$882.00
Payments of cash dividends	-$19,097.00	-$62,967.00	-$77,170.00
Repurchases of common stock	-$616.00	-$967.00	-$6,896.00
Net cash provided (used) by financing activities--continuing operations	-$292,172.00	-$490,994.00	-$843,961.00
Net cash used by financing activies--discontinued operations	---	---	-$306,527.00
Net cash provided (used) by financing activities	-$292,172.00	-$490,994.00	-$1,150,488.00
Net increase (decrease) in cash and cash equivalents	$36,443.00	-$202,224.00	$539,560.00
Cash and cash equivalents at beginning of year	$1,141,518.00	$1,343,742.00	$804,182.00
Cash and cash equivalents at end of year	$1,177,961.00	$1,141,518.00	$1,343,742.00
			Source: KB Home 10-K

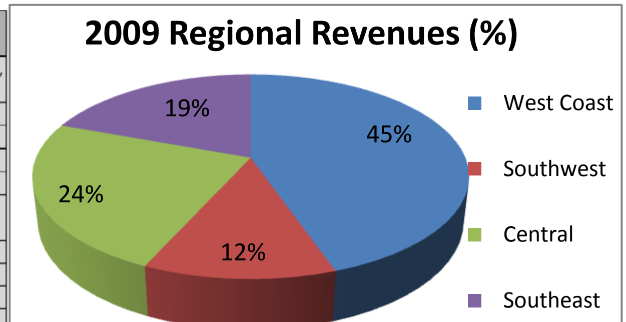
According to the statement of cash flows, KB Home ended the fiscal year of 2009 with $1.17 billion, up from $36 million from the fiscal year of 2008. The net cash from operating activities was nearly $350 million while the investing activity brought a negative $21 million and financing activities further contributed to a negative $292 million. Examining the payments of dividends to shareholders, it is evident that KB Home made significant dividend cuts to save cash. As a signaling effect, this indicates that KB Home still feels very uncertain about the future prospects of the business and may continue to experience difficult times.

Segment Analysis

KB Home reports to five individual segments, four of which are based on homebuilding locations and one financial services report segment.

Region	State(s):	KB Home: Major Markets Counties
West Coast	California	Fresno, Los Angeles/Ventura, Orange County, Riverside, Sacramento, San Bernardino, San Diego, San Jose/Oakland and Stockton
Southwest	Arizona	Phoenix and Tuscon
	Nevada	Las Vegas and Reno
Central	Colorado	Denver
	Texas	Austin, Dallas/Fort Worth, Houston, and San Antonio
Southeast	Florida	Daytona Beach, Fort Myers, Jacksonville, Lakland, Orlando Sarasota and Tampa
	Maryland	Washington, D.C.
	North Carolina	Charlotte and Raleigh
	South Carolina	Charleston and Columbia
	Virginia	Washington, D.C.

Source: KB Home 10-K



Source: KB Home 10-K

KB Home Reporting Segments (In thousands): West, Southwest, Central, Southeast	Year Ended November 30, 2009	2008	2007
West:			
Revenues	$812,207.00	$1,055,021.00	$2,203,303.00
Income (loss) from continuing operations before income taxes	-88442	-298047	-$665,845.00
Equity in income (loss) of unconsolidated joint ventures	-$7,761.00	-$45,180.00	-$64,886.00
Inventory impairments	$44,895.00	$229,059.00	$631,399.00
Inventory abandonments	$32,679.00	$17,475.00	$28,011.00
Joint venture impairments	$7,190.00	$43,116.00	$57,030.00
Southwest:			
Revenues	$218,096.00	$618,014.00	$1,349,570.00
Income (loss) from continuing operations before income taxes	-$48,572.00	-$212,194.00	-$287,339.00
Equity in income (loss) of unconsolidated joint ventures	-$15,509.00	-$35,633.00	-$15,734.00
Inventory impairments	$28,833.00	$160,574.00	$337,889.00
Inventory abandonments	---	$187.00	$16,479.00
Joint venture impairments	$5,426.00	$30,434.00	$31,049.00
Central:			
Revenues	$434,400.00	$594,317.00	$1,077,304.00
Income (loss) from continuing operations before income taxes	-$29,382.00	-$82,789.00	-$64,210.00
Equity in income (loss) of unconsolidated joint ventures	$506.00	-$4,515.00	-$6,916.00
Inventory impairments	$23,891.00	$51,518.00	$24,662.00
Inventory abandonments	---	---	$9,783.00
Joint venture impairments	---	$2,629.00	$4,483.00
Southeast:			
Revenues	$351,712.00	$755,817.00	$1,770,414.00
Income (loss) from continuing operations before income taxes	-$78,414.00	-$258,568.00	-$230,420.00
Equity in income (loss) of unconsolidated joint ventures	-$26,851.00	-$67,422.00	-$64,381.00
Inventory impairments	$23,229.00	$124,726.00	$116,023.00
Inventory abandonments	$14,622.00	$23,252.00	$89,736.00
Joint venture impairments	$25,915.00	$65,671.00	$63,801.00

Source: KB Home 10-K

The segment figures show that the West region produced a significant amount of revenue for the fiscal year of 2009 relative to the other regions at $812 million, or accounting for 45% of the total revenues. Respectfully, the Central region, Southeast region, and Southwest region followed in revenues by segment. All revenues are significantly depressed from previous years. The regions containing troubled areas (Southeast, West, and Southwest) which included the states of Nevada, California, Arizona, and Florida, saw the largest income losses from continuing operations as a percentage of total revenues in the fiscal year of 2009 and previous years. This is in line with expectations given that KB Home operates in many states with depressed housing markets.

Financial Services- KB Home Mortgage Company (KBHMC)

KB Home Financial Services (In Thousands): KB Home Mortgage Company (KBHMC)			
		Year Ended November 30,	
	2009	2008	2007
Revenues			
Interest income	$31.00	$209.00	$158.00
Title services	$1,184.00	$2,369.00	$5,977.00
Insurance commissions	$7,220.00	$8,189.00	$9,193.00
Escrow coordination fees	---	---	$607.00
Total	$8,435.00	$10,767.00	$15,935.00
Expenses			
Interest	---	---	---
General and administrative	-$3,251.00	-$4,489.00	-$4,796.00
Operating income	$5,184.00	$6,278.00	$11,139.00
Equity in income of unconsolidated joint venture	$14,015.00	$17,540.00	$22,697.00
Pretax income	$19,199.00	$23,818.00	$33,836.00
Assets			
Cash and cash equivalents	$3,246.00	$6,119.00	$18,487.00
Receivables	$1,395.00	$1,240.00	$2,655.00
Investment in unconsolidated joint venture	$28,748.00	$44,733.00	$23,140.00
Other assets	$35.00	$60.00	$110.00
Total assets	$33,424.00	$52,152.00	$44,392.00
Liabilities			
Accounts payable and accrued expenses	$7,050.00	$9,467.00	$17,796.00
Total liabilities	$7,050.00	$9,467.00	$17,796.00
			Source: KB Home 10-K

KB Home Mortgage Company generated revenues of $8.4 million for the fiscal year of 2009 and maintained a total asset base of $33 million in this period. Both figures have dwindled down from numbers from the previous two years. Insurance commissions are responsible for generating the majority of the income, and have leveled off at a lesser rate than other facets of the mortgage business in terms of revenue generation. This financing arm needs to continue to be cautious of cash on hand as cash levels are nearly one-sixth of that in 2007.

SWOT Analysis

KB Home: SWOT Analysis	
Strengths	Weaknesses
Very reputable and established homebuilder	Saturation in the housing market
Low mortgage rates spur housing demand	Exposure to Nevada, California, Arizona, and Florida
KB Home Mortgage Company vertically integrated into business model	Depressed revenue stream and ongoing losses
Diversified housing in the US	Currently difficult for homebuyers to secure credit
Opportunities	Threats
Government stimulus has positively impacted KB Home relative to competitors	Continued 'Shadow Inventory' of mortgage delinquencies and foreclosed homes
Obama's tax plan to first-time home buyers	Increased unemployment
KB Home can take advantage of cheaper land acquisitions	Lower demand for mortgages in private investment
Potential to gain market share	Undergoing SEC investigation

Strengths:

- Very reputable and established homebuilder

  Fortune Magazine has ranked KB Home the #1 homebuilder in Fortune Magazines' *Most Admired Companies* three times in the past four years. KB Home has a long standing history and was the first publicly traded homebuilder on the New York Stock Exchange.

- Low mortgage rates spur housing demand

  Mortgage rates are currently at the lowest levels since 1972 which has been designed to stimulate the housing market. The Fed's $1.25 billion mortgage buy-back program has helped keep rates low. Though the Fed ended this program on March 31, 2010, analysts believe that private investment in mortgages will continue to keep rates low.

- KB Home Mortgage Company vertically integrated into business model

  In a joint venture with Countrywide, KB Home's mortgage subsidiary will allow buyers to access credit through the subsidiary to purchase homes from KB Home. This will help eliminate buyer demand that is hurt by restricted credit. Competitors may have difficulty of integrating a financing arm into their business model due to current economic stresses and difficulty in obtaining lending capital. Further, this helps KB Home serve as a "one-stop shop" to potential homebuyers.

- Diversified housing in the US

  KB Home currently operates in four regions of the United States: West Coast, Southwest, Central, and Southeast. This helps eliminate over-exposure and excess concentration in any one location. From 2008 to 2009, KB Home sought opportunities in four new states, gaining an overall exposure in twelve states. However, in the future KB Home should continue to seek diversification to hedge total portfolio risk.

Weaknesses

- Saturation in the Housing Market

  Competition from other homebuilders who continue to have high inventories will weigh on profit margins and demand for KB Home properties. The current foreclosed inventory contains 9-10 months of home sales and could get worse considering that residential mortgages past due or going through foreclosure add up to another 15 months of home sales[4].

- Exposure to Nevada, California, Arizona, and Florida

  KB Home currently has much exposure in Nevada, California, Arizona, and Florida. The real estate in these three states has suffered the most in the country since the economic contraction. Consequently, the short-term upside potential in these markets is very low given that conditions may continue to worsen before improving due to the 'shadow inventory' of upcoming foreclosures[16].

- Depressed revenue stream and ongoing losses

  KB Home has had a significantly smaller revenue stream with mounting losses over the past few years (2009 Revenues- $1.84 Billion vs. 2007 Revenues- $6.4 billion). As a result, KB Home has had to make numerous land and asset sales below costs to help stay well capitalized. Poor economic conditions can continue to depress revenue streams and increase net losses as well as force KB Home to make more asset sales to maintain a financially sound balance sheet[1]. KB Home has faced three straight years of negative earnings per share.

- Currently difficult for homebuyers to secure credit

  Though mortgage rates are extremely low, many potential homebuyers struggle to secure credit at such a low rate, or even at all. The low interest rates do not imply that everyone has access to credit. As a result, housing demand suffers since many potential buyers have difficulty receiving credit.

Opportunities

- Government stimulus has positively impacted KB Home relative to competitors

Roughly 78% of total mortgages on houses purchased from KB Home have been government insured or guaranteed. Only their competitor MDC Holdings has a similar amount to KB Home at just under 80%, while the industry average is about 57%4. This greatly reduces the volatility on the mortgages outstanding on homes sold by KB Home and grants KB Home more direction going forward.

- Obama's Tax Plan to First-Time Home Buyers

Obama has signed a piece of legislation that gives an $8,000 credit to stimulate the housing market for first-time home buyers[11]. KB Home receives 80% of its revenue from first-time homebuyers so most of the customers fit the profile to receive the credit. The industry average for first-time homebuyers is 47% so KB Home should have a strong advantage over its competitors[4].

- KB Home can take advantage of less expensive land acquisitions

The economic downturn has significantly reduced the cost of land in most areas of the United States. KB Home currently has 4.3 years of land supply while the industry average of land supply is 6.4 years, according to Bank of America Merrill Lynch[4]. Given the economic conditions, a smaller amount of land supply indicates that KB Home has more cash on hand and less liquidity constraints than most of its competitors. This allows KB Home to make new acquisitions at very low prices. This can be very advantageous if KB Home properly identifies opportunistic areas.

- Potential to gain market share

Since 2007, hundreds of privately held homebuilders have been forced into bankruptcies based on the conditions of the housing market and general economy[7]. As the industry has seen much consolidation over the past few years, KB Home can seek to gain market share as conditions recover if it maintains financial strength and stays strategically positioned.

Threats

- Continued 'shadow inventory' of mortgage delinquencies and foreclosed homes

More mortgage defaults and foreclosed homes will continue to saturate the housing market and prolong high housing inventories. This will continue to heavily weigh on recovery in the housing market. According to S&P analysts, the 'shadow inventory' could take up to three years to clear the market which would pose a significant threat to KB Home and other homebuilders[16].

- Increased unemployment

  If unemployment continues to worsen in the United States, housing demand will remain poor with weakened consumer confidence, difficulty in obtaining credit, and continued economic uncertainty.

- Lower demand for mortgages in private investment

  The Fed's $1.25 billion mortgage buyback program has been keeping rates artificially low. The Fed ends the program on March 31, 2010 and suspects that private investment will continue to keep rates low. The low rates will then continue to stimulate the housing market. If private investment in the market responds negatively as the Fed winds down this liquidity program, rates could rise quickly resulting in weakened demand for new houses.

- Undergoing SEC investigation

  On 10/09/2009 KB announced that the SEC began an undefined investigation on the firm. Though uncertain, analysts cite that this is most likely due to the lack of transparency regarding their inventory impairment analysis and accounting procedure[17]. This investigation could worry investors, hurt the company's reputation, and potentially monetarily costly.

  Further, the former CEO, Bruce Karatz, is currently accused by the SEC for backdating stock options. While he is still undergoing investigation, reports show that he made $6.62 million more than he should by retroactively selecting the dates he was to have received his stock option grants[18]. Though no longer CEO, this could also bode negatively for investors if Karatz is found guilty due to qualitative concerns over company management and firm-wide ethics.

Strategic Recommendations

Challenges

KB Home will face numerous challenges in the foreseeable future. The most concerning challenge is the general condition of the United States housing market and economy. Though a few indicators in the housing markets have stabilized and general economic conditions have improved, the housing market will remain extremely fragile for some time. Of interest to the housing market, foreclosed inventory currently comprises 9-10 months of home sales while the amount of residential mortgages past due or in foreclosure add another 15 months of home sales, which will continue to weigh to saturate the market. This 'shadow inventory' of bank-repossessed properties and distressed mortgages provides an extreme amount of uncertainty as to what levels of inventory these homes will add to the market and makes it difficult to predict when these homes will clear the market so inventories can revert back to historical averages. In terms of economic conditions, unemployment and other economic uncertainty continues to weigh on the economy which will continue to adversely impact consumer confidence. Other challenges stem from competition in the homebuilding industry as other homebuilders continue to shift business towards first-time home buyers, which has always been KB Home's strongest line of business. Further, the portfolio exposure of KB Home in extremely depressed areas in Nevada, Arizona, California, and Florida will continue to increase difficulty for the firm.

Short Term Recommendations

Financial Strength & Cash

In the short term, KB Home will need to maintain financial strength to continue to meet near term obligations while maintaining a strategic position in the industry. The first priority for KB Home is to maintain a steady level of cash on the balance sheet to continue to pay debt and maintain financial strength. With negative earnings per share over the past couple of years along with a heavily reduced stream of revenues during this time, keeping high levels of cash on the balance sheet will be key given the market conditions. This may come at the expense of land or asset sales, but given the uncertainty and high volatility of the housing market, will be imperative to stay well capitalized until housing market and economic conditions further stabilize.

Asset Sales in Distressed Markets & Purchases in Opportunistic Markets

Currently, KB Home has an advantageous position relative to its competitors in the respect that it holds 4.3 years of land supply relative to an industry average of 6.4 years. The "short land" position bodes favorably towards KB Home, offering more flexibility with future purchases and market liquidity. With much discipline and adequate research, KB Home can make new land acquisitions at very low prices in different markets. Though it has been previously identified that cash will be key for KB Home, KB Home should consider making asset sales in distressed areas and use the generated cash for new opportunities in housing markets with better recovery prospects. KB Home needs to continue to strategically examine attractive new areas of expansion while generating cash from land and asset sales in areas with very low upside potential. KB Home should continue to maintain lower years of land supply relative to its competitors given the market conditions, but needs to strive to find land with the highest growth prospects to fulfill the acquired land supply. As improving condition warrant increasing positions of land supply, KB Home will need to do so to maintain strong positioning relative to its competitors.

Maintain Focus on the First-Time Buyer & Increase Affordability Initiatives

KB Home has been relatively well-positioned throughout the housing crisis having maintained a constant focus on the first-time homebuyer consistent with its long-term business model. The first-time homebuyer has received aid in the form of an $8,000 government tax credit as well as easier access to credit. Over the past few years, the number of homes delivered and average price per house have both sharply decreased, conveying the common themes of market saturation and buyer power. Other competitors have been moving into the first-time homebuyer space to take advantage of the perks for first-time homebuyer, implying a more competitive environment for KB Home with more need for differentiation. KB Home will need to further broaden its offering to the first-time homebuyer to stay competitive in the market space. The strategic recommendation is to continue with the ‘Open Series’ line of more customization and efficiency options, however, create communities with smaller lot sizes and living spaces to undercut the competition and make the house even more affordable. This would further help diversify KB Home’s portfolio within the first-time homebuyer market.

Long Term Recommendations

Broaden Portfolio Exposure in the United States

Currently, KB Home operates in twelve states in the country. However, before the beginning of the housing crisis, KB Home only had a presence in eight states, giving its business portfolio very little diversification. Ultimately, declines in only of a few of these housing markets would ultimately increase the volatility of KB Home’s business operations. By diversifying into more areas of the country, the implicit risk and exposure to any given market that KB Home assumes will be much less. This would ultimately give KB Home a much more stable business in the long-run that will be more on par with the total housing conditions in the United States. Further, if any housing markets within KB Home's portfolio began to show more downside than initially expected, KB Home would be able to easily use its economies of scale to shift resources to other areas in its portfolio that appear more opportunistic.

Penetration into the Community Development Market

KB Home should strongly consider expanding operations into community development as opposed to solely focusing on homebuilding. The development of malls and other commercial real estate will strongly complement the current homebuilding model of KB Home while offering diversification within its business. Given that the value of houses is strongly influenced by the surroundings in the community, KB Home can use further community development initiatives to increase the value of its homes as the surroundings will be more desirable for residents. Expansion into this territory would give KB Home more control over the entire community of the houses it is developing. KB Home could also consider teaming with a counterparty that specializes in community development to create a joint-venture by developing full communities.

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