Earnings Quality: Summary Reports on Individual Companies
Lennar Corp.: A Case of Lagging Cash Flow

EXECUTIVE SUMMARY
After struggling in the period 2007-2009, Lennar Corp. enjoyed stable earnings for the years ended November 30, 2010 and 2011. Operating cash flow, however, has fallen short of the company’s earnings improvement. This cash flow deficiency can be attributed to several factors, including:

Increasing inventory – due to investments in homes and land, inventory increased to 514.2 revenue days in 2011, up from 495.1 days in 2010 and 478.3 in 2009.

Loss of prior-year income tax refunds - operating cash flow was boosted in 2010 and 2009 by tax refunds of $341.8 million and $241.8 million, respectively. The company paid $12.0 million in income taxes in 2011 and, in the absence of future losses, will not receive future tax refunds.

A reduction in the deferred tax valuation allowance boosted income temporarily by $32.6 million in 2011 and $83.5 million in 2010 with no accompanying increase in operating cash flow.

Analysts and investors interested in Lennar Corp. will want to pay close attention to the cash flow shortfalls the company is experiencing. Data were provided by Cash Flow Analytics, LLC in which Charles Mulford is a principal.

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Georgia Tech Financial Analysis Lab
The Georgia Tech Financial Analysis Lab conducts unbiased research on issues of financial reporting and analysis. Unbiased information is vital to effective investment decision-making. Accordingly, we think that independent research organizations, such as our own, have an important role to play in providing information to market participants.

Because our Lab is housed within a university, all of our research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Our focus is on issues that we believe will be of interest to a large segment of stock market participants. Depending on the issue, we may focus our attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in our work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. We define earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, our research may look into reporting practices that affect either earnings or cash flow, or both. At times, our research may look at stock prices generally, though from a fundamental and not technical point of view.

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Earnings Quality: Background and Definition
Earnings quality is an evaluation of the extent to which a firm’s earnings are generated from sustainable sources that are backed by cash flow. There are two dimensions to earnings quality: the persistence and cash flow dimensions. In examining the persistence dimension of earnings quality, we identify whether reported earnings have been boosted by nonrecurring items. For example, earnings increased by a nonrecurring gain from an asset sale or a one-time reduction in the effective tax rate due to a tax-loss carryforward would impair earnings quality on the persistence dimension. In evaluating the cash dimension of earnings quality, we seek to determine whether reported earnings are supported by cash flow. For example, cash flow would lag earnings for a company that has provided its customers with extended payment terms or that has accumulated inventory in anticipation of increased future sales. Such lagging cash flow would impair earnings quality on the cash dimension.

Earnings that are of low quality increase the likelihood that future earnings will decline from current levels. This is not to say that future earnings will decline, but the likelihood of a decline is increased for companies with low earnings quality. For example, in the case of the nonrecurring gain or the low effective tax rate, future earnings will decline when that gain is excluded or the tax-loss carryforward is no longer available. For the firm that has provided extended payment terms or that has accumulated inventory, future earnings will decline if the resulting receivables or accumulated inventory cannot be realized and writedowns ensue.

In assessing earnings quality, the balance sheet also plays an important role. We use the term position quality to refer to the effects of the balance sheet on earnings quality. We say that position quality is impaired when assets are carried at amounts that exceed fair value or when obligations are carried at less than the amounts needed to liquidate them. Companies that accumulate overvalued assets or undervalued liabilities will see their earnings decline when those overvalued assets are written down or those undervalued liabilities are written up. For example, at some point an investment in a debt security of a financially-troubled issuer that is held to maturity and carried at cost will need to be written down. Similarly, a charge will be needed to increase the balance of an underaccrued warranty obligation. In both instances future earnings will suffer.

The purpose of our summary reports on individual companies is to enable us to focus our attention on one or more dimensions of earnings quality. For example, we might identify nonrecurring gains that we think have impaired a company’s earnings on the persistence dimension. Or, declining cash flow may be our focus, impairing earnings quality on the cash dimension. Finally, for some firms we may look at the balance sheet where position quality may be impaired due to overvalued assets or undervalued liabilities.

A Caveat
In our reports we are not saying that we believe that the earnings or stock price of the company in question will decline. Rather, we are pointing out what we have found in publicly available filings that we think is worthy of closer scrutiny by analysts and investors.
Lennar Corp.
Lennar Corporation engages in homebuilding, financial services, and real estate businesses in the United States. The company builds single-family attached and detached homes and provides mortgage financing, title insurance and closing services for the buyers of its homes and others. The company also invests in distressed real estate.

The company’s fiscal year ends November 30. Amounts are reported in millions and are for the twelve months ended November 30.

The Cash Flow Shortfall
After struggling in the period 2007 – 2009, Lennar Corp. enjoyed stable earnings for the years ended November 30, 2010 and 2011. Net income (from continuing operations attributable to Lennar) were $92.2 million and $95.3 million, respectively, for the years ended November 30, 2011, up from losses of $417.1 million, $1,109.1 million and $1,941.1 million, respectively, for 2009, 2008 and 2007.

Net Income (from Continuing Operations)

Operating cash flow, however, has fallen short of the company’s earnings improvement. From a recent high of $1,100.8 million in 2008, operating cash flow has fallen each year, turning negative in 2011 at -$259.1 million.

Operating Cash Flow

Source: Cash Flow Analytics, LLC

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With the decline in operating cash flow comes an accompanying decline in the company’s free cash flow.

**Free Cash Flow**

![Free Cash Flow Chart](chart.png)

Source: Cash Flow Analytics, LLC

The observed lag in operating cash flow relative to net income manifests as a decline in the earnings quality indicator, EQI. EQI measures the quality of earnings on the cash dimension. The metric incorporates changes in operating cash flow and net earnings in a single measure.

**Earnings Quality Indicator (EQI)**

![Earnings Quality Indicator Chart](chart.png)

Calculated as (Operating Cash Flow – Income from continuing operations) / Revenue

Source: Cash Flow Analytics, LLC
Key Factors Contributing to the Cash Flow Shortfall

(1) Inventory increased to $4,360.5 million in 2011 up from $4,169.6 million in 2010, driven primarily by an increase in land and land under development to $2,636.5 million in 2011 from $2,223.3 million in 2010. Inventory is increasing faster than revenue, resulting in an increase in inventory days.

It should be noted that reported inventory excludes inventory reclassified to operating properties and equipment in the amount of $126.5 million in 2011. Included in inventory are the inventories of newly-formed or previously unconsolidated entities in the amount of $52.9 million, $84.0 million and $360.6 million in 2011, 2010 and 2009, respectively.

![Inventory Days Chart](image.png)

Source: Cash Flow Analytics, LLC

(2) The company paid income taxes of $12.0 million in 2011 while receiving cash tax refunds of $341.8 million, $241.8 million and $877.0 million, respectively in 2010, 2009 and 2008. Income tax receipts and payments are included with operating cash flow. As such, in years prior to 2011, operating cash flow was boosted temporarily by cash tax refunds stemming from the company’s prior-year losses. In the absence of future losses, tax refunds from loss carrybacks should not be expected in future years.

(3) The company carries a net deferred tax asset of $576.9 million at 2011. That asset represents the tax savings from future tax deductions in the form of a net operating loss carryforward as well as operating expenses recorded on the financial statements that have not yet been deducted on the company’s tax return. Given the uncertainty that exists surrounding realization of the future tax deductions, the company has fully reserved its deferred tax asset. However, that reserve was reduced by $32.6 million in 2011 and $83.5 million in 2010. Adjustments to the deferred tax valuation reserve serve to reduce income tax expense (creating a tax benefit in 2011 and 2010) and increase net income (though not on a recurring basis). Such increases in net income do not result in an increase in operating cash flow.
(4) Other factors impacting operating cash flow include receivables, which consist of amounts due from customers for home sales and mortgages on properties sold. Receivables increased by $132.3 million in 2011, reducing operating cash flow, declined by $340.4 million in 2010, increasing operating cash flow, and increased by $117.9 million in 2009, reducing operating cash flow. An increase in other assets reduced operating cash flow by $113.5 million in 2011. The effects in prior years were minimal. A decline in payables and other liabilities reduced operating cash flow by $106.8 million in 2011, $120.9 million in 2010 and $95.9 million in 2009.

(5) While not impacting reported operating cash flow, the company does disclose problems with obligors on the company’s mortgage receivables. The firm disclosed that it acquired $467.7 million and $186.0 million in real estate owned in 2011 and 2010, respectively, in satisfaction or partial satisfaction of loans receivable. The conversion of mortgage notes to real estate owned will impact future operating cash flow through reduced interest income.

**In Summary**
Analysts and investors interested in Lennar Corp. will want to pay close attention to the cash flow shortfalls the company is experiencing. In particular, for the reasons cited, the earnings improvements the company has enjoyed have not been accompanied by improvements in operating cash flow, which has now turned negative.