



# SNL Financial Services Daily

Reprinted from SNL Financial

Thursday, August 10, 2006

## Morgan Stanley rides the wave with \$706 million purchase of Saxon Capital

by Gabe LeDonne

Extending the growing trend between investment banks and mortgage lenders, Morgan Stanley said Aug. 9 that it agreed to purchase residential mortgage lending and servicing REIT Saxon Capital Inc. in a deal valued by SNL Financial at \$706.1 million, or \$14.10 per share.

Based on Saxon's capital structure, including 50,080,215 shares of common stock at June 30 and 3,000 options with a weighted average strike price of \$10.10 at March 31, SNL Financial values the deal at \$706.1 million.

Using Saxon's March 31 financials, SNL's deal value represents 118.59% of book value, 21.46% of originations, 10.83% of net receivables, 8.60x last-12-months (LTM) earnings per share and 2.60x LTM revenues.

Pending customary regulatory and shareholder approvals, the acquisition is expected to be completed by the end of 2006.

New York-based Morgan Stanley said that the acquisition supports its strategy of building a "global, vertically integrated residential mortgage business" and that Saxon will complement its other initiatives to strengthen its mortgage franchise over the past eight months in the United States, Europe and Asia.

In December 2005, Morgan Stanley purchased Advantage Home Loans, a U.K.-based mortgage packager. In June 2006, the firm's securitized products group acquired an Italian mortgage bank and servicer.

"Saxon builds on our existing origination and securitization capabilities by providing us with an extremely strong servicing platform," Anthony Tufariello, global head of Morgan Stanley's securitized products group, said in a news release. "This is an important part of the residential mortgage business, and the addition of Saxon will further enhance our risk management of mortgage portfolios. This deal also provides Morgan Stanley with new origination capabilities in the non-prime market, which we can build upon to provide access to high-quality product flow across all market cycles."

The executive said that the addition of Saxon to Morgan Stanley's global mortgage franchise will help it capture the "full economic value inherent" in the business and put the firm in a better position to leverage its competitive advantages in trading, risk transfer, credit and structuring, as well as in hedging mortgage credit risk.

Morgan Stanley's purchase of Saxon came as no surprise most investors and analysts, as the company had publicly stated its desire to vertically integrate its mortgage business in the past, which in itself is nothing new among investment banks.

Both Lehman Brothers Holdings Inc. and Bear Stearns Cos. have adopted similar strategies, while foreign banks like Deutsche Bank AG and Barclays Plc have made acquisitions to add either origination or servicing scale.

"We are seeing continued vertical integration within the mortgage banking sector, particularly most recently by the broker/dealers in the non-prime space, since the broker/dealers are the end users of the loans," Milestone Advisors LLC Managing Director Jeffrey Levine told SNL. Milestone served as an adviser for Morgan Stanley in the Saxon transaction.

Keefe Bruyette & Woods analyst Bose George told SNL that, in attempting to "vertically integrate" mortgage operations, the investment banks are looking to "lock up" origination flow for their securitizations.

"It seems like the investment banks, in the slowing volume environment, are trying to lock up some flow for their conduits as well and trying not to get cut out," he said, "Now, that's the reasoning," he added. "I don't know if I buy that reasoning. The mortgage market is sort of a fungible product — people are all bidding against each other — so I don't know if locking up flow is necessarily a valid [reason]."

The competitive and slowing mortgage market has also helped deals from the seller's side, as it forces smaller lenders, including mortgage REITs, to consider their strategic alternatives, the analyst said.

"I think most of the guys see the writing on the wall that originations are going to slow, sale margins are going to slow, and credit is going to become an issue over the next couple of years," George said. "And given what's going to be an extremely rough environment, those who are going to be able to survive are going to be the bigger lenders."

And for mortgage REITs in particular, Levine said that there are "a few interesting dynamics" influencing companies towards a sale.

"One, the capital structure of the REIT model is not conducive to growth strategies in the current flat yield curve and tighter operating margin environment," he said. "Since REITs are required to distribute 90% of their taxable portfolio earnings to maintain REIT tax-status, they must rely on new equity from the public markets for growth capital. With portfolio earnings (and as a result dividends) under pressure from the flat-yield curve, the cost of this new capital is more expensive."

As a result, Levine said that some otherwise solid operating businesses are being "capital-constrained from a growth perspective," thus potentially leading companies to consider a sale.

"Two, there are the normal underlying M&A drivers as well, including lower cost of funds, revenue and expense synergies, economies of scale, and market share. Combine the capital structure issue with these generic M&A drivers, and you naturally have an increased number of REITs exploring strategic alternatives," he added.

**Morgan Stanley** *continued*

And indeed, Saxon's sale announcement follows about a month after Deutsche Bank AG said that it would acquire MortgageIT Holdings Inc., and less than three months after Accredited Home Lenders Holding Co. said that it would acquire Aames Investment Corp.

But, as KBW's George pointed out, "After every refi boom there has been waves of consolidation, and this is another one of those waves," though he added that the additional element this time around is that investment banks are joining in on the consolidation.

Glen Allen, Va.-based Saxon Capital was ranked the United States' 14th-largest nonprime servicer by managed assets in 2005, servicing approximately \$26 billion of nonprime residential mortgage loans, Morgan Stanley said. Saxon also purchases, originates and securitizes nonprime residential mortgages. Its mortgage loan portfolio totaled \$6.5 billion at March 31.

Morgan Stanley was the lead adviser on the transaction and was also advised by Milestone Merchant Partners LLC.

Saxon was advised by Credit Suisse Securities (USA) LLC, who rendered a fairness opinion to Saxon's board. Saxon's legal advisers were Gibson Dunn & Crutcher LLP and Ballard Spahr Andrews & Ingersoll LLP.

**COMPANIES REFERENCED IN THIS ARTICLE:**

<b>MortgageIT Holdings Inc.</b>	<b>MHL</b>
<b>Close: \$14.62 -0.01 (-0.1%)</b>	<b>Vol: 111,300 (39% of Avg.)</b>
<b>Aames Investment Corp.</b>	<b>AIC</b>
<b>Close: \$4.11 -0.50 (-10.8%)</b>	<b>Vol: 710,600 (189% of Avg.)</b>
<b>Accredited Home Lenders Holding Co.</b>	<b>LEND</b>
<b>Close: \$34.99 -7.29 (-17.2%)</b>	<b>Vol: 6,835,083 (849% of Avg.)</b>
<b>Deutsche Bank AG</b>	
<b>Morgan Stanley</b>	<b>MS</b>
<b>Close: \$64.68 -1.60 (-2.4%)</b>	<b>Vol: 6,121,500 (136% of Avg.)</b>
<b>Saxon Capital Inc.</b>	<b>SAX</b>
<b>Close: \$13.84 +2.87 (+26.2%)</b>	<b>Vol: 16,381,500 (3,157% of Avg.)</b>

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