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MORTGAGE BANKING M&A

2006 Review and 2007 Outlook

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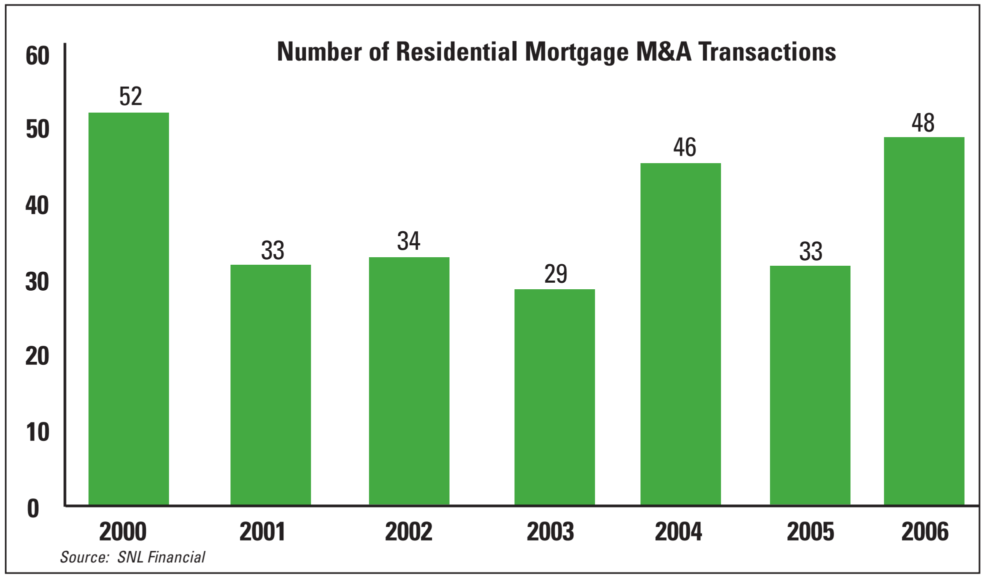
A Tale of Two Markets

With consumer expenditures representing approximately 70 percent of U.S. gross domestic product, it would be a fair assumption that consumer trends would dominate economic and capital market performance. Ironically, two sectors of the capital markets are operating at opposite spectrums. The equity markets are setting new record highs, S&P 500 corporate earnings have realized double-digit growth over the past 13 quarters (3Q06), corporate America has ready access to the liquidity markets, unemployment is near historic lows, wage growth is increasing and consumer confidence remains strong.

The mortgage market is operating at the opposite spectrum, with the yield curve remaining inverted, ABS/CDS credit spreads widening, origination volumes markedly lower, housing inventories at historic highs, mortgage delinquencies rising, and the pace of mortgage product innovation attracting scrutiny and regulatory oversight. The non-prime mortgage sector has faced the strongest headwinds, with excess capacity, fixed cost burdens, aggressive underwriting standards, and compressed gain on sale margins burdening the profitability of the business model.



Excess capacity is driving consolidation (Aames, Champion, Encore, First Franklin, Saxon) and exit (NetBank, Ownit, Sebring), with other participants also exploring strategic alternatives (ABN AMRO Mortgage, Ameriquest/Argent, Fieldstone, Option One). Many of the subprime operators are trading below book value and well below their 52-week high, as are some of the prime active mortgage real estate investment trusts (REITs) that are suffering from diseconomies of scale in a lower volume and thinner margin environment.

At this juncture last year we titled the article, "A Slow 2005 Clears the Way for a Busy 2006"; our prophetic verse proved accurate. The pace of mortgage M&A

Source: SNL Financial Pricing Date: 01/03/07	% of 52W High	Total Rate of Return			Price/Book		
		3 Month	1 Year	3 Year	1/3/07	2005Q4	2004Q4
Prime Mortgage Banks	91%	11.8%	18.1%	41.4%	151.4%	147.4%	189.3%
Subprime Mortgage Banks	65%	-7.0%	-21.9%	23.4%	104.5%	152.7%	234.5%
Prime Active REITs	70%	-7.9%	-13.6%	63.3%	105.9%	124.2%	161.2%
Prime Passive REITs	95%	11.8%	40.5%	-1.6%	113.5%	88.1%	131.6%
Subprime Active REITs	56%	-10.2%	-17.8%	-17.7%	96.4%	109.8%	260.9%

transactions increased nearly 50 percent in 2006. There were 48 mortgage-industry M&A transactions announced/completed in 2006, compared to 33 transactions during the course of 2005. The three key themes for the 2006 mortgage M&A period can be best described as (i) Wall Street vertical integration, (ii) REIT capital preservation, and (iii) bank capital rationing.

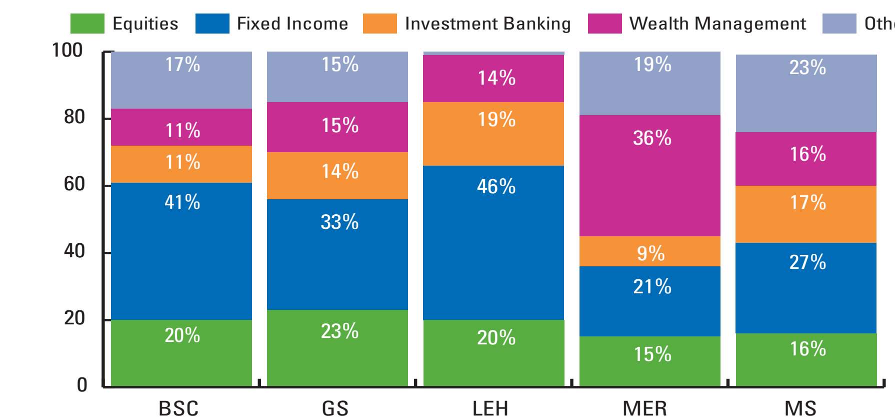
Wall Street Vertical Integration

2006 has been hailed as one of the best, if not the ultimate best year for the investment banking industry. Private equity activity has monopolized the headlines, with the value of announced deals rising to a record $700 billion, more than double the record set in 2005 and 20 times larger than 1996, according to Thomson Financial. It would be natural to assume that investment banking would be the key driver to Wall Street's revenue flow, but the revenue chart below illustrates that fixed income represents the dominant force. With the mortgage market representing the largest sector of the domestic bond market, mortgages and the corresponding swap/cap/floor/CDS/CDO products will continue to attract Wall Street attention.

Acting as the predominant buyer and distributor of mortgage product to the investment community, Wall Street's continued pursuit of vertical integration serves to better control the execution flow. Just as a steel producer would benefit from owning iron ore mines to manufacture the end product, Wall Street's ability to secure the "raw materials" to "manufacture" the bonds further immunizes their execution from market forces. Proficiency and scale in servicing and special servicing, thereby delivering best of class risk management and cash flow productivity, supports the sponsorship of the securitization shelf across various interest rate, prepayment and credit cycles. Therefore, vertical integration within origination, servicing and capital markets provides greater breadth of economic opportunities and further immunization from market forces across evolving mortgage market cycles.

Milestone believes that the Wall Street conduits will continue to be active in the 2007 M&A market, with specific focus on non-agency/third-party channel companies. Affordability products were a primary driver of the increase in homeownership rates over the prior years, and will continue to be a market segment experiencing attractive long-term secular growth. The non-agency market is skewed to adjustable-rate loans, with greater prepayment propensity and product innovation; the more active "flow" in the ARM sector moderates the origination cyclicality and reduces the operating leverage from fixed cost burdens. The third-party channel circumvents the brick and mortar presence that is more akin to the depositories in their deposit gathering franchises, and affords more scale than the retail model.

Wall Street's core strengths in capital markets, product innovation, and risk-based pricing lend well to this market segment. Milestone expects Wall Street conduits will maintain long-term strategic interest in the non-agency and non-prime sectors, making opportunistic book value/discount acquisitions in origination platforms, while also augmenting/fortifying servicing competency. Companies with attractive broker networks will be absorbed into existing conduits, while second tier companies will be forced to liquidate their portfolios/pipelines and shut down their platforms.



Source: Company Reports

Buyer	Target	Announce Date	Deal Value ($M)
Bear Stearns	Encore Credit Corp	10/10/06	26.0
Merrill Lynch	First Franklin / NationPoint	9/5/06	1,310.0
Morgan Stanley	Saxon Capital	8/9/06	706.1
Merrill Lynch	Freedom Funding	7/26/06	NA
Deutsche Bank	MortgageIT Holdings	7/11/06	431.4
Barclays	HomeEq Servicing	6/22/06	469.0
Deutsche Bank	Chapel Funding	5/17/06	NA

Source: SNL Financial

REIT Capital Preservation

The mortgage REIT sector is also a bifurcated market: most prime passive REITs have enjoyed year-over-year total returns (including dividends) ranging from 30 to 50 percent and are trading near their 52W highs, while the prime active REITs have realized losses of 15 percent on average. It appears that the passive REITs are priced to a combination of higher coupon resets, improved premium amortization and expectations of Fed monetary easing. The active REITs are suffering from lack of

Source: SNL Financial Pricing Date: 01/03/07	INITIAL PRICE OFFERING		MOST RECENT OFFERING		CLOSING	BOOK VALUE	
	Date	Price	Date	Price	Price	2006Q3	2005Q4
American Home Mortgage	NA	NA	Aug-05	$35.50	$35.12	$22.52	$21.62
Annaly Capital Management	Oct-97	$12.00	Aug-06	$12.30	$13.91	$11.26	$10.73
Anworth Mortgage Asset Corp.	Mar-98	$9.00	Aug-03	$14.30	$9.51	$9.75	$9.61
Capstead Mortgage Corp.	Sep-85	$13.80	Feb-92	$22.07	$8.30	$8.16	$8.48
Deerfield Triarc Capital Corp.	Jun-05	$16.00	NA	NA	$16.93	$13.78	$13.50
ECC Capital Corp.	Feb-05	$6.75	NA	NA	$1.19	$2.07	$2.84
Fieldstone Investment Corp.	NA	$17.50	NA	NA	$4.38	$9.03	$10.86
Hanover Capital Mortgage	Sep-97	$15.00	Aug-03	$10.00	$4.97	$7.66	$7.00
HomeBanc Corp.	Jul-04	$7.50	Feb-05	$9.10	$4.23	$4.72	$5.59
Impac Mortgage Holdings Inc.	Nov-95	$8.67	Nov-04	$23.00	$8.80	$11.94	$13.24
Luminent Mortgage Capital Inc.	Dec-03	$13.00	Oct-06	$10.25	$9.71	$9.75	$9.76
MFA Mortgage Investments Inc.	NA	NA	Feb-04	$10.13	$7.69	$7.37	$7.05
New Century Financial Corp.	Jun-97	$7.33	Sep-04	$58.00	$31.59	$33.61	$35.17
New York Mortgage Trust Inc.	Jun-04	$9.00	NA	NA	$3.05	$4.47	$5.61
NovaStar Financial Inc.	Oct-97	$9.00	May-05	$35.00	$26.65	$12.80	$15.08
Opteum Inc.	Sep-04	$14.50	Dec-04	$15.50	$7.60	$8.41	$10.33
Origen Financial Inc.	May-04	$8.00	NA	NA	$6.85	$7.85	$7.85
Redwood Trust Inc.	Aug-95	$15.50	Sep-04	$58.60	$58.08	$40.02	$37.20
Thornburg Mortgage Inc.	Jun-93	$15.00	Jun-05	$30.80	$25.13	$20.03	$20.00

scale in a lower origination environment and lower gain on sale execution: losses at the TRS subsidiaries are causing erosion of book value, thus constraining growth and fading the sponsorship of the REIT stock price. The above table illustrates the book value erosion among several of the REIT operators and the stock performance in reference to the IPO date and recent secondary capital raises.

The REIT structure is proving burdensome in managing investor expectations, limiting capital erosion, and navigating equity market cycles for efficient capital raising. Recent experience validates that the business model necessitates scale, with market share gains accruing to the lowest cost originators who can secure broker flow through competitive coupon pricing. Milestone expects continued consolidation and exit among the smaller active REITs lacking the scale to absorb the expense burden of being public, along with the diseconomies of scale from lower originations.

In the non-prime arena, the inability to retain capital has caused duress for operators facing increasing repurchase activity. A greater proportion of transactions in 2007 may be transacted as asset sales to limit liability exposures from repurchase activity. Additionally, non-prime active REITs may consolidate their TRS subsidiaries into larger origination platforms, maintaining sufficient capital within the REIT to satisfy any pending repurchase claims. Milestone also expects REITs trading at book value or at a discount to book value to become acquisition targets, acting as a capital raise for acquiring REITs at a lower cost than a public equity issuance.

Bank Capital Rationing

While Wall Street conduits are expanding, banks are repositioning and exiting segments of the mortgage business. Commitment to the sector has been challenged by the volatility of mortgage earnings, technology infrastructure demands, the capital intensity and hedging complexity of mortgage servicing rights, and the lower earnings multiples assigned to mortgage earnings. Banks continue to sell (Irwin, KeyCorp, National City, Union Federal), restructure (NetBank, Sovereign), and explore strategic alternatives (ABN AMRO).

Milestone expects that banks will continue to shed mortgage exposure in their third-party and out-of-footprint operations in 2007 (narrow margins and limited cross-sell opportunities), while housing the prime retail mortgage business within the bank's consumer banking stewardship. A longer term trend on the horizon is the ramp of reverse mortgage products; the prominence of hybrid mortgages and interest only mortgages has advanced consumer education on financial alternatives, and we expect the retail brick and mortar franchises to increasingly engage consumers in the reverse mortgage market. The secondary market for reverse mortgages is rapidly advancing, and disclosure within IndyMac's 10-Q's indicates that the Financial Freedom franchise (acquired from Lehman Brothers in July 2004) holds strong promise.

Summary

The mortgage market will continue to be in search of a new equilibrium in 2007 as excess capacity and thinner margins challenge the financial endurance of marginal industry participants. Platform scale will enable the lowest cost originators to capture market share, as less price competitive and less deeply capitalized participants seek strategic partners or exit the business. Milestone expects the subprime sector to be the most active in 2007.

The Early Payment Default loan repurchase activity has created liquidity failures, with highly leveraged independent companies being the most directly exposed. The subprime credit performance of 2006 vintage loan production is proving to be among the worst of all vintages and will continue to exert influence in 2007, in addition to the flow of coupon resets in the coming year to "stated income/purchase" borrowers that will encounter a narrower breadth of refinance opportunities. Milestone also expects the private equity and hedge fund community, acting as a hybrid of a strategic buyer and a distressed buyer, to increase their acquisition interest in the non-prime sector in 2007.

Alain Toto is a vice president at Milestone Advisors, LLC, an investment-banking firm headquartered in Washington, D.C. with an additional office in Miami. Milestone provides merger and acquisition advisory and corporate finance services to financial services companies, including mortgage, commercial, and consumer finance companies, banks, thrifts, and insurance companies. The views expressed in this article are solely those of the author.