

Introduction

In last year's *Mortgage Banking Industry Outlook*, we proposed that executives begin to consider and anticipate the following:

- Flat or higher rates will compress margins
- Servicing values may not appreciate enough to fully offset lost production earnings
- RESPA and other pending regulatory issues will impact business models
- Product diversification, especially HELOC's and subprime, will be used to replenish lost volume
- Companies that considered leaving the business prior to 2001 may revisit this option as volumes fall and servicing values increase

We believe that these same issues are, in fact, already starting to materialize. But, not all is doom and gloom! Sure times are going to get tough and some players will leave the business. However, as the facts below suggest, new capital (both private and public) continues to flow into the sector, and savvy acquirers are using the changing environment to grow their businesses:

- There were more than 50 mortgage banking platform and portfolio acquisitions announced in 2003
- Over 10 Initial Public Offerings and Private Placements, representing over \$5 billion in new capital, are currently in process
- GE has re-entered the business with the announced acquisition of subprime lender WMC Mortgage
- Citibank continues to aggressively expand with its recently announced acquisition of Principal Residential Mortgage

With all of this in mind, we offer the following observations and suggestions that will help you react effectively to the changing environment as you execute your mortgage banking strategies for the coming year. As always, please feel free to use the information and share it with others!

"The Correction Could be Large"

The general consensus in the mortgage industry is that the origination market has probably peaked and the respite we experienced a few months ago is likely to subside. The momentum from the refinance boomlet of early 2004, coupled with the seasonal spring pick-up in home sales, will probably sustain pipelines through early summer, but many mortgage banking executives we have spoken to recently are planning for a more challenging business environment during the second half of 2004 and throughout 2005.

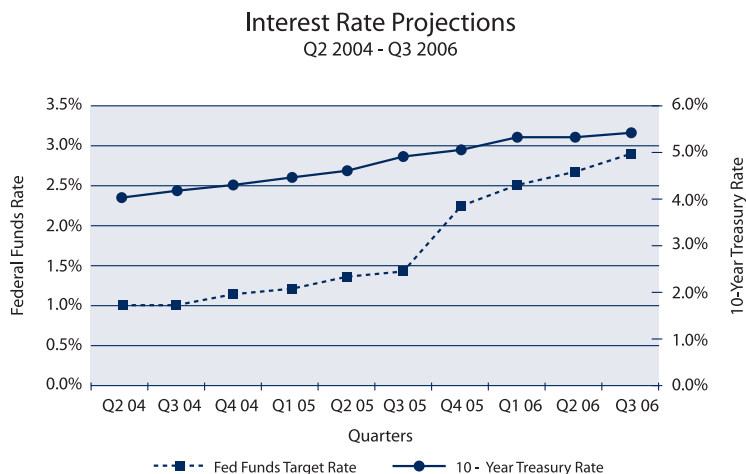
As the chart on the right shows, the interest rate correction following a period of sustained origination volumes can be quite large. The average increase in the 10-year Treasury yield from trough to crest following the 1986, 1993 and 1998 refinance booms was 240 basis points.

10 Year Treasury Yield (1985 - Present)



Current projections have the Fed Funds Target Rate increasing by almost 200 basis points between Q2 – 2004 and Q3 – 2006, with the 10-Year Treasury rate increasing by about 150 basis points. (See chart on right.)

Over the past 8 weeks, the average 30-year fixed rate increased nearly 100 bps, from 5.37% to 6.32%. This does not bode well for refinance-focused origination shops in that these increases will certainly reduce volumes, margins and warehouse spreads. For lenders with servicing portfolios, the rate increase should result in MSR value appreciation, helping to offset some of the production-related drop in earnings.



As an owner or a mortgage banking executive, if you have not updated your rate shock analyses and staffing models, now is the time to do so! Milestone can assist you in evaluating alternative business forecasts and strategies.

“Public and Private Equity”

As mentioned earlier, both public and private equity continues to enter the mortgage sector. There were over 10 REIT offerings completed within the past 12 months representing over \$2.5 billion in capital. These included both private placements and IPO’s/follow-on offerings such as American Home Mortgage’s acquisition of Apex Mortgage Capital and subsequent \$300 million follow-on offering, and Fieldstone Capital’s private placement of approximately \$700 million.

As of June 1st, there were at least 10 additional offerings in the pipeline totaling more than \$6 billion in capital. These included both established lenders, predominantly Alt-A and subprime companies such as New Century, Aames and Saxon, as well as predominantly conforming originators such as HomeBanc, New York Mortgage and Mortgage IT.

The current REIT structure offers mortgage lenders the following advantages:

- Portfolio capability for ARM, Alt-A and Niche product
- Capital at attractive yields, providing stock currency to acquire other lenders or assets
- Liquidity for the sponsoring taxable entity
- Diversify earnings stream

The recent rise in interest rates, however, has slowed down the REIT initiative, particularly for conforming lenders. This is primarily due to market concerns over falling volumes, narrowing margins and volatile rate sensitivity on leveraged investment portfolios.

We think that the non-conforming lender REIT offerings will close, but at lower pricing levels. As a result, some of these lenders may choose alternative strategies including private equity or sale to a strategic buyer.

Private institutional investors remain very interested in the mortgage sector, willing to back proven management teams, business models and franchises. Most of the investments will be with lenders focused on niche strategies such as subprime, Alt-A, consumer direct or strong traditional retail. Recent transactions include:

- Thomas Lee/Putnam's investment in ResMAE Financial Corporation
- CIVC Partners' investment in Oakmont Mortgage

Finally, the correction in the public markets will give strategic buyers an advantage, even over a private equity investor. The benefits of growth capital, parent balance sheets and long-term strategic commitment to the business may outweigh the dilution in equity ownership. This was certainly one of the considerations behind WMC Mortgage's recently announced sale to GE Capital, as the owners of WMC had evaluated alternative strategies including an IPO.

Milestone assists lenders in evaluating alternative capital raising vehicles. These include private companies, both conforming and non-conforming, as well as bank-owned specialty lenders.

“RESPA Reform/Packaging”

The much-discussed RESPA reform proposed by HUD has been withdrawn, to the relief of many lenders who feared increased competition from real estate agents and undue pricing advantages of large companies.

Despite its withdrawal, many of the initiatives that the RESPA reform spawned have taken root, particularly guaranteed pricing and one-stop shopping for mortgage and realty services. Borrowers are looking for simplicity and we believe that lenders who offer “one-stop” and “one-fee” product offerings will be more successful.

- Early-adopter ABN AMRO Mortgage Group continues to expand its “OneFeeSM Mortgage” program across all of its production channels
- One-price, internally-packaged settlement services provided via title company joint ventures was the platform behind many successful consumer-direct No-Cost Streamline Refinance transactions in 2003
- A 2002 Harris poll confirms that 82% of homebuyers preferred “one-stop” shopping for their mortgage and real estate transactions, up from 58% in 1999

The packaging initiatives that support a “one-fee” program have led to increased activity in the title and vendor services sector. Many lenders have set up vendor services, affiliated business arrangements and other joint ventures to both streamline processes, and effect volume discounts and additional fee income. This, in turn, has led to continued consolidation of vendor service providers, driven by the large title companies, as they look for economies of scale, market share and vertical integration of the mortgage support business:

- Fidelity National's acquisition of Alltel Information Services which includes the industry-leading Mortgage Servicing Platform (MSP)
- First American's acquisition of TransAmerica's flood and tax service businesses
- Numerous acquisitions of independent title and settlement companies by the top title insurers

With established contacts at many of the large vendor service providers, Milestone can assist you in evaluating a joint venture or packaging arrangement.

“Merger and Acquisition Activity”

A fall-off in production and lift in servicing values always leads to M&A activity in the mortgage banking sector. In fact, we are already seeing deal flow increase with Citi’s announced acquisition of Principal and IndyMac’s pending acquisition of Financial Freedom. There are other transactions in process, mostly involving independent originators or smaller servicers, as these firms look to align themselves with larger institutions and monetize the equity in their companies.

We do not believe we will see a massive exodus of bank-owned mortgage companies. Instead, we expect a number of banks to downsize their operations, particularly wholesale/correspondent and out-of-footprint franchises that have lower margins and offer limited corporate strategic benefits. These downsizes may be either shutdowns or structured sales, and may be coupled with a bulk sale of non-core, non-bank footprint servicing rights.

Other non-bank owned players such as Cendant Mortgage may continue to explore strategic alternatives, much like Principal did; however, the relationships these lenders maintain with other affiliates of their parent corporation may make an outright sale transaction more complicated.

Milestone represents both independent and bank-owned lenders in the sale of their mortgage companies.

“Bank M&A Implications”

The past 6 months have also seen a dramatic increase in bank and thrift mergers and acquisitions activity at all ends of the spectrum – national, regional and community. This consolidation activity will directly and indirectly impact mortgage banking consolidation.

On the large scale, Bank of America and Fleet merged, as did JP Morgan Chase and Bank One. Since both Fleet and Bank One had, for the most part, previously left the first mortgage business, there were not as many overlap concerns in the mortgage divisions.

As can be seen with the Regions/Union Planters merger, we also believe that substantial merger activity will take place among the Super Regional banks, many of which have large or established mortgage operations.

Finally, institutions planning a bank sale may elect to sell their mortgage companies first. This strategy was a consideration in two recent Northeast bank deals – Staten Island Bancorp’s merger with Independence Community Bank (where SIB Mortgage was sold prior to the bank merger) and GreenPoint Bank’s explored spin-off/sale of Greenpoint Mortgage before GreenPoint’s ultimate merger with NorthFork Bank.

Milestone has a great deal of experience working with both mortgage company subsidiaries and parent companies in handling the mortgage component of a broader bank M&A transaction.

“From the Owner’s Point of View”

The past 3 years have, for the most part, been extremely satisfying, but also very exhausting. In fact, for many lenders and management teams, this is the third, if not fourth, refinance wave they have experienced. And, as we previously mentioned, times are only going to get more challenging!

Bank-owned mortgage companies should evaluate the following:

- How are earnings going to be maintained or replaced?
- Is our company positioned to capture market share?
- Do out-of-footprint operations still make sense?
- Is the mortgage company consuming capital and liquidity that could be used by other areas of the bank?
- Do we have the scale to successfully compete in a lower-margin environment?
- Has our Treasury group effectively hedged the MSR asset as part of the bank’s total Asset/Liability position?

Independent lenders have equally important issues to consider:

- Will our operations, particularly wholesale divisions, maintain their profitability in the post-refinance environment?
- Do we have the quality and depth of management to lead us through the tougher market that lies ahead?
- Are the owners still committed to keeping their personal net worth and liquidity invested in the company?
- Would a merger or acquisition with a larger lender take the franchise to the “next level”?
- Is the business model we’ve developed creating long-term franchise value?
- Do we have an adequate succession plan and exit strategy in place?

“The Milestone Advantage”

As you evaluate these strategic alternatives, let Milestone’s experience in the mortgage banking sector work for you. We continue to be involved in all facets of the Mortgage Banking M&A and Corporate Finance arena, as the following transactions represent:

- The sale of **SIB Mortgage Corp.**, a nationwide lender, by Staten Island Bancorp/Independence Community Bank Corp. – April 2004
- The acquisition of Synergistic Marketing, Inc., a mortgage down-payment assistance provider, by **AmeriDream, Inc.** – January 2004
- The sale of **Oakmont Mortgage**, a West-Coast based subprime lender in its sale to CIVC Partners – December 2003
- The private placement of \$25 million in convertible preferred stock for **ResMAE Financial Corporation**, a California-based subprime lender – October 2003

Our team of experienced investment bankers, combined with relationships we maintain with the industry's leading hedge consultants, servicing and loan brokerage advisory firms and public underwriters, can assist you in any of the following strategic engagements:

- Corporate sale or acquisition
- Mortgage origination franchise or servicing platform sale
- Equity or subordinated debt offering
- Review of pipeline hedging and risk management strategies
- Strategic review for bank or parent board
- Corporate valuation
- Loan portfolio and servicing portfolio valuation and brokerage

Please contact any of the following Milestone professionals to discuss these strategic issues further:

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