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New Rec: Accredited Home Lenders (LEND:\$29.17) July 18, 2004

Position: Buy Target: \$40.00 Timing: 2 (1=aggressive; 5=cautious)

\$MM	1Q04a	2Q04e	3Q04e	4Q04e	FY2003a	FY2004e	FY2005e
Revenue	118,963	147,845	158,185	170,999	435,222	595,993	787,184
EPSS	1.05	1.54	1.37	1.41	4.97	5.38	5.78
Y/Y Gr	23.5%	23.5%	-2.2%	0.2%	151.0%	8.2%	7.5%
PSR	na	na	na	na	1.4	1.0	0.8
PE	na	na	na	na	5.9	5.4	5.0
Consensus	na	1.54	1.42	1.47	na	5.47	5.87

Shares Out: 20.8M

Market Cap: \$606.7M

FYE: Dec

Summary: Accredited Home Lenders Holdings Co. (LEND) is a nationwide mortgage banking company that originates, finances, sells, securitizes and services non-prime mortgage loans secured by single-family residences. During FY2003, about 89% of LEND's origination was derived from its wholesale channel of over

6800 mortgage brokers and about 11% was derived from about 30 retail outlets throughout the US.

LEND is currently trading at \$29.17, down 30% from its 52-week high of \$41.43 reached on January 22, 2004. Even before the Fed raised rates at the end of June, LEND shares were hit hard due to concerns that anticipated interest rate increases will significantly dampen the mortgage lending market by putting an end to the 3-year refinancing boom. However, we think that investors are overly discounting the non-prime mortgage lenders, and LEND in particular, by not differentiating LEND from other mortgage lenders. The non-prime borrower base differs from the prime borrower base by being less sensitive to interest rate increases. Whereas traditional borrowers tend to refinance their homes when interest rates decline, non-prime borrowers will refinance or take equity loans against their homes to consolidate higher cost debt or to use the cash for medical or other needs. As evidence, only 8% of LEND's 1Q04 volume was from rate and/or term refinances, while 50% was from cash-out refinance and debt consolidation. Non-prime borrowers tend to be overextended on credit and will continue to need cash regardless of the interest rate environment. We therefore think that non-prime mortgage lenders will not be hit as hard if interest rates rise, and therefore should not be discounted to the same degree as prime mortgage lenders.

Furthermore, housing demand remains strong, and borrowers will probably continue to purchase new homes even with measured increases in interest rates. The Mortgage Bankers Association (MBA) estimates that total mortgage originations for 1-to-4 family residences (comprised of refinancings and new home purchases) will decline 34% by 2004. However, the majority of this decline is due to refinancings projected to decline by 58%. New home purchase originations are actually expected to increase by 12% in 2004. We think that LEND's business will therefore not be significantly impacted by rising rates, since 42% of its 1Q04 originations were from new home purchases.

Our observation about the characteristics of non-prime borrowers would suggest that the non-prime market does not necessarily follow the same cycle as the prime market, which makes up the vast majority (over 90%) of the total mortgage market. Comparison of the growth statistics for the two segments supports this theory. During 1Q04, when refinancing activity already began to show signs of decline, originations in the total non-prime market grew 71% y/y, while prime originations decreased by 41%. Secondly, this could be attributable to the fact that the non-prime market, a much smaller and less mature market, would experience higher growth rates for a number of years before its growth rate converges with that of the prime market.

Since 1999, management has increased both revenues and earnings by at least 50% annually. During 1Q04, LEND brought in mortgage originations of \$2.4B, a 63% y/y increase. Although Q1 is the slowest season of the year, this represents the highest volume ever in LEND's 14-year history. From 2002 to 2003, LEND increased its originations by 85%. Of the total \$105.6B of non-prime mortgages originated in 1Q2004, LEND's \$2.4B of originations represented only 2.3% of the market, leaving substantial room for market share growth. LEND continues to expand its platform, increasing total employees to 2,081 in 1Q04 from 1,471 a year prior.

LEND management attributes its continued profitability to its disciplined "profit culture" that emphasizes an incentive based structure and utilizes innovative technology to compensate employees for pricing profitable, high quality loans, not for merely generating volume. Another feature of LEND's profit culture is the sharing of fully-loaded profit and loss data across divisions in order to promote internal competition and motivate sales and operations managers to optimize profitability of their divisions and therefore their resulting compensation. Management recently raised its 2Q04 EPS guidance to \$1.50-\$1.60 from \$1.25-\$1.35, and its FY2004 EPS guidance to \$5.30-\$5.60 from \$5.00-\$5.25.

Management also intends to improve the quality of its earnings by growing its on-balance sheet loan portfolio. This will result in more recurring interest income from on-balance sheet securitizations relative to one-time gains from whole loan sales. During FY2003, LEND generated 24% of its net revenue from interest income compared to 71% from one-time gains on sale. Management intends to increase the recurring interest income component to 50% of its earnings by the end of 2005. We expect this change in revenue mix to reduce volatility and improve predictability of LEND's earnings, thereby resulting in future earnings multiple expansion.

The offset to the improved recurring revenue base, however, will be the increased risk from holding more loans. By carrying more loans on its balance sheet, LEND is exposed to increased prepayment and default risk. This risk is minimized by management's conservative lending practices and the rigor of its loan process from point of origination to collection. This conservative approach is reflected in LEND's credit statistics that compare favorably against the rest of the non-prime industry.

To begin with, LEND's loans have an average credit score of 634, and make up the upper end of the non-prime market in terms of credit quality (a credit score of 620 or less is typically considered non-prime). LEND's portfolio consists predominantly of first lien mortgages. LEND also has lower loan-to-value (LTV) in its industry, as well as the highest percentage of owner occupied mortgages. All

these factors suggest that LEND should experience lower default rates relative to its peers. Indeed, LEND's portfolio delinquency rates also compare favorably to the peer average.

LEND management has also demonstrated significant improvements in managing its portfolio risk over time. LEND continues to improve the credit quality of its loans over time. This is evident when we compare LEND's loss experience by vintage. As of March 31, 2004, the cumulative net losses 38 months after origination totaled improved from 2.42% for vintage 1999 loans, to 2.09% for vintage 2000 loans, and finally to 0.65% for vintage 2001 loans.

LEND's business model depends on its ability to finance and acquire mortgages and to resell/securitize them at a profit. LEND therefore requires available short-term credit facilities as well as an open and liquid market to buy its loan portfolios. LEND's track record as a high quality originator should enable LEND to continue to obtain liquidity to fund its originations. LEND's continued access to the whole loan and securitization markets is indicative of the market demand as well as of the quality of LEND's loan portfolio. Furthermore, LEND's recurring pool of top-tier trading partners is a testament to its track record as a high quality originator. In 2002, 2003 and Q12004, Household, Morgan Stanley and CSFB consistently represented the top three loan portfolio investors. During those periods, other repeat investors included Lehman Brothers, Goldman, Sachs & Co., Bank of America, GMAC/RFC and Countrywide.

The non-prime mortgage market is subject to numerous risks. Although non-prime borrowers are less sensitive to interest rate changes, a significant rise in rates in a short timeframe could negatively impact non-prime mortgage loan volume. Continued economic weakness could negatively impact housing prices, and reduce the available equity borrowers can borrow against. LEND derives over 30% of its business from California, where real estate values may be overheated. However, considering the size of California's economy relative to the rest of the nation, and relative to the % of CA holdings in peer portfolios, LEND's concentration in CA does not seem excessive. This risk is also mitigated by LEND's geographic expansion into all 50 states. The mortgage lending industry is already highly regulated by local, state and federal laws, and the trend is toward more regulation. Many states and cities have passed or are considering "anti-predatory lending" regulations. LEND adopts conservative lending practices to avoid this inference. The non-prime market is a highly competitive business. In the last few years, Fannie Mae and Freddie Mac have increased their penetration in the nonconforming residential lending market, creating concern that their practices could affect industry dynamics (paying lower fees to buy loans) due to their size. Also, irrational pricing practices by competitors vying for volume in a declining market could jeopardize industry margins.

Considering the risks described above, we think that LEND shares are still trading at a significant discount (even after the 12% rally over the recent three trading days) and provide attractive upside potential. With consensus EPS for LEND at \$5.47 for FY2004 and \$5.87 for FY2005, LEND currently trades at a mere 5.0x FY2004 consensus EPS. Even assuming minimal origination volume growth in 2005 (5.6%) and lower whole loan sale premiums and interest income spread, we expect LEND to continue to generate earnings, and to eventually realize an earnings multiple expansion. We estimate EPS to be \$5.38 for FY2004 and \$5.78 for FY2005 (EPS growth rate of 7.5%). We think these estimates are conservative. Based on the 2005 P/E multiple of LEND's comparable universe, we think a multiple of 7.0x is appropriate. LEND's non-prime peers are trading at a mean FY2005 EPS multiple of 7.0x and a median multiple of 7.3x. Applying a 7.0x multiple to our estimated 2005 EPS of \$5.78 results in a target price of \$40.00. We are therefore setting a 12-month price target of \$40.00, a potential 37% upside.

Background:

Founded in 1990, Accredited Home Lenders Holdings Co. (LEND) is a nationwide mortgage banking company that originates, finances, sells, securitizes and services non-prime mortgage loans (less flatteringly referred to as sub-prime or non-conforming loans) secured by residential real estate. LEND focuses on borrowers who may not meet conforming underwriting guidelines because of higher loan-to-value ratios, the nature or absence of income documentation, limited credit histories, high levels of consumer debt or past credit difficulties. Non-prime loans typically consist of more cash-out refinancings and purchase loans, and fewer interest rate driven refinancings. Non-prime borrowers typically view the equity in their homes as a savings account to be tapped into as needed.

During FY2003, approximately 89% and 11% of LEND's loans were originated through its wholesale and retail channels, respectively. Wholesale loan originations were originated through approximately 6,800 brokers, 400 account executives, and 7 division offices across the country with additional satellite offices. The retail channel originated mortgages through about 280 loan officers working in 30 retail branches. The retail outlets operate under the names Axiom Financial and Home Funds Direct, and generate leads primarily through telemarketing, direct mail and the Internet. At March 31, 2004, LEND employed 2081 employees in 50 states. LEND has greatly increased its market presence in the past several years through a growing sales force and geographic expansion.

Of the \$332B non-prime loans originated in 2003, LEND originated about \$8.0B, which represented a 2.4% market share. During 1Q04, typically the slowest

quarter of the year, LEND originated \$2.4B of loans. Business volume tends to peak in spring and summer (Q2 and Q3).

LEND uses various warehouse credit facilities to fund its loan originations. It then sells or securitizes the mortgage loans within three to four months of origination, and pays down the warehouse credit facilities with the proceeds. LEND's warehouse facilities generally have a one-year term. At March 15, 2004, LEND had total credit capacity of \$2.7B from eight different warehouse lenders.

Prior to 2002, LEND sold all of its loans through whole loan sales or "off-balance-sheet" securitizations, recognizing immediate gains from these sales. Loans sold through whole loan sales are generally sold in pools to financial buyers who usually repackage and sell the loans through their own securitizations.

Beginning 3Q2003, LEND also utilized "on-balance sheet" securitizations, which provide permanent financing for the loans held on the company's balance sheet. LEND holds and services the loans, and receives the interest spread over the life of the loans, effectively deferring the recognition of revenue. As a result of overcollateralization and certain credit enhancement features, LEND is able to issue investment-grade asset-backed securities.

During 1Q04, LEND sold approximately 66% of its loan originations through whole loan sales and funded 21% through on-balance sheet securitizations. The balance of originations was held for sale. During 1Q04, 30% of earnings resulted from the on-balance sheet securitizations. Management intends to increase revenues generated from its on-balance sheet portfolio to 50% by end of 2005.

LEND's portfolio of loans at March 31, 2004 totaled \$4.0B, and consisted of \$1.9B held for sale, and \$2.1B securitized. At quarter end, LEND also carried \$271M of off-balance sheet securitizations. LEND no longer sells these loans with retained interest. Accordingly, this amount, along with the \$4.3M mortgage-related securities on LEND's balance sheet, will continue to decline. LEND's portfolio consists of about 66% adjustable rate mortgages (ARMS) and 33% fixed rate mortgages.

Discussion:

1. The non-prime mortgage market is less sensitive to interest rates, and will likely continue to grow even if interest rates rise moderately.

The trading multiples of the broader mortgage lending industry have been hit hard recently due to investor concern that anticipated rate increases will negatively impact the mortgage lending industry. LEND is no exception, considering it is

currently trading at a 5.1x forward P/E multiple (this multiple was 4.7x prior to the recent three-day rally). The mortgage lending industry has enjoyed a 3-year refinancing boom and is expected to take a hit as interest rate increases. However, we argue that the non-prime mortgage industry does not necessarily follow the same cycle as the prime mortgage industry, and is less volatile in a rising rate environment. We think that investors are erroneously classifying non-prime lenders into the same category as prime mortgage lenders, therefore discounting the non-prime mortgage lenders more than they should.

The non-prime borrower base differs from the prime borrower base in that it is less sensitive to interest rate increases. Whereas traditional borrowers tend to refinance their homes when interest rates decline, non-prime borrowers will refinance or take equity loans against their homes to consolidate higher cost debt or to use the cash for medical or other needs. As evidence, only 8% of LEND's 1Q04 volume was from rate and/or term refinances, while 52% was from cash-out refinance and debt consolidation. Non-prime borrowers tend to be overextended on credit and will continue to need cash regardless of the interest rate environment. We therefore think that non-prime mortgage lenders will not be hit as hard if interest rates rise, and therefore should not be discounted to the same degree as prime mortgage lenders.

Furthermore, the housing market has remained strong, and borrowers are likely to continue to purchase new homes even with measured increases in interest rates. The Mortgage Bankers Association (MBA) estimates that total mortgage originations for 1-to-4 family residences (comprised of refinancings and new home purchases) will decline 34% from \$3.8 trillion in 2003 to \$2.5 trillion in 2004, and another 28% to \$1.8 trillion in 2005. However, the majority of this decline is due to refinancings projected to decline 58% in each of 2004 and 2005. New home purchase originations are actually expected to increase by 12% in 2004 and decline by only 6.5% in 2005. Even if the refinancing business dries up in a rising-rate environment, LEND's business should not be significantly impacted, since 42% of its 1Q04 originations were from new home purchases.

Our observation about the characteristics of non-prime borrowers would suggest that the non-prime market cycle is not nearly as pronounced as the prime cycle, where borrowers are more rate-sensitive. Comparison of the growth statistics for the prime and non-prime segments supports this theory. During 1Q04, when refinancing activity already began to show signs of decline, originations in the total non-prime market grew 71% y/y, while prime originations decreased by 41%. Also, the prime market makes up the vast majority (over 90%) of the total mortgage market. It is possible this could be attributable to the fact that the non-prime market, a much smaller and less mature market, would experience higher

growth rates for a number of years before its growth rate converges with that of the larger prime market.

Total non-prime originations for 2003 totaled \$332B. Although total mortgage originations are expected to decline by 34%, B&C Insight projects the non-prime market to grow to \$438M in 2004 (32% increase) and decline back down to \$373M in 2005 (15% decrease).

As further indication that non-prime volume remains strong in Q204, on July 8, 2004, NCEN announced that its June 2004 loan production volume of \$4.9B was up 20% from \$4.1B in May 2004, and up 145% from \$2B in June 2003.

2. Management continues to deliver consistent revenue and earnings growth.

While the MBA reported a 21% y/y decline in mortgage originations during 1Q04, LEND actually increased its loan origination by 63% during the same period. During this seasonally slow quarter, LEND brought in mortgage originations of \$2.4B, the highest ever in its 14-year history. From 2002 to 2003, when the MBA reported that total mortgage originations increased 53%, LEND increased its origination by 85%. From 1999 to 2003, LEND's origination volume has grown by a compounded annual growth rate of 64%.

Of the total \$105.6B of non-prime mortgages originated in 1Q2004 (Inside B&C Lending), LEND's \$2.4B of originations represented only 2.4% of the market, leaving substantial room for market share growth.

Management expects future growth will come from growth in platform as well as improved efficiency. Management plans to increase its employee base at an appropriate pace. LEND has increased total employee base to 2,081 in 1Q04 from 2,056 in 4Q03, and 1,471 in 1Q03. Seven new salespersons were also added in 1Q04. Management has found it increasingly difficult to recruit and retain management talent, and has thus created a 12-month management trainee program, recruiting heavily from 45 college campuses. While this is a costly program, management notes that these trainees (roughly 100 in the pipeline currently) ultimately contribute disproportionately to the firm's productivity.

LEND management emphasizes that its "business is not just about origination; it is about originating loans with borrowers who pay you back." LEND management attributes its continued profitability to its disciplined "profit culture" that includes an incentive based structure as well as a technology called the Revenue Calculator. The Revenue Calculator provides front line personnel with loan price information on a real time basis, and enables them to see how modifications they make increase or decrease the value of the loan in the secondary

market, and therefore how it affects their compensation for that loan. LEND's loans are also underwritten twice, by the origination team and again by an experienced corporate underwriter. Furthermore, loan losses are allocated back to the origination team by LEND's profit/loss accountability system.

This technology is also set up to enhance compliance with "predatory" lending laws. For example, it contains controls that are designed to eliminate economic incentives to employees for structuring unfair loans to the borrower (e.g., if loan features are changed to excessively increase the cost to the borrower, the impact to the loan value and thus the compensation to the employee is capped.) Loan origination personnel are therefore paid for producing profitable loans, not just high loan volume. Many competitors still compensate salespersons based on volume, and this shows in the statistics of many of LEND's competitors. Management also promotes a competitive culture that results in improved profitability for the firm. By making fully burdened division profit/loss data available to all team members, management promotes a healthy level of internal competition. Management also ensures profitability of the firm by compensating each team's operations and sales managers based on their teams' profitability.

3. Strategy of growing on-balance sheet portfolio will improve quality of earnings and lead to earnings multiple expansion.

Once large pools of originations are accumulated, LEND either 1) sells the entire pool of loans to financial buyers who repackage and sell the loans through their own securitizations ("whole loan sales" or "off-balance-sheet" securitizations), or 2) securitizes the pool of loans in its own name and retains the loans on its own balance sheet ("on-balance sheet securitization"). LEND's loan portfolio at March 31, 2004 totaled \$4.0B, and is comprised of \$1.9B held for sale, and \$2.1B securitized.

For whole loan sales, LEND records a one-time gain from sale and generally transfers all risks to the buyers. For on-balance sheet securitizations, LEND receives permanent financing for the securitized bonds, pays off its short-term warehouse facility, and holds the loan balance on its balance sheet. Rather than recording a large one-time gain, LEND receives and records the interest spread over the life of the loans, effectively deferring the recognition of revenue.

Prior to 2002, LEND sold all of its loans through whole loan sales. It began to utilize on-balance sheet securitizations in 3Q2003. During 1Q04, LEND sold approximately 66% of its loan originations through whole loan sales and funded 21% through on-balance sheet securitizations. The balance of originations was held for sale. This mix resulted in 36% of 1Q04 earnings from on-balance sheet securitization. This compares to 83% sold through whole loans sales during 2003.

LEND intends to make this a bigger part of its business, increasing earnings generated from its on-balance sheet portfolio to 50% by the end of 2005. This will result in a larger base of guaranteed, recurring future interest income relative to one-time gains from loan sales. We expect this to be a positive step toward expanding its earnings multiple through improved predictability and lower volatility of future earnings.

4. Increased risks from larger on-balance sheet portfolio are mitigated by LEND's conservative underwriting practices and disciplined loan management process.

Offsetting the benefit of predictable future earnings is the increased risk from holding more loans. By carrying more loans on its balance sheet LEND is exposed to increased prepayment and default risk. However, management addresses the increased risk through its conservative lending practices and efficient collection efforts (LEND services these loans). For 2003, 26.5% of LEND's securitized loans were prepaid. LEND seeks to minimize prepayment risk by originating a significant portion (over 90%) of its loans with prepayment penalties with terms of two to five years. Management's conservative approach is reflected in its credit statistics which compare favorably with its non-prime peers.

To begin with, LEND's loans have an average credit score of 634, and make up the upper end of the non-prime market in terms of credit quality (a credit score of 620 or less is typically considered non-prime). LEND is only one of a couple non-prime lenders whose portfolio consists predominantly of first lien mortgages. LEND also has the low loan-to-value (LTV) relative to the industry, as well as the highest percentage of owner occupied mortgages.

All these factors suggest that LEND should experience lower default rates relative to its peers. We compared LEND's portfolio delinquency rates to its peers for a couple of vintages, and found that this was indeed true. For vintage 1999 loans, LEND had cumulative net losses of 2.6% for vintage 1999 and 2.1% for vintage 2000. This is substantially lower than the peer average. We did not compare the results from more recent vintages because they do not have enough loss experience to be meaningful.

LEND management has also demonstrated significant improvements in managing its portfolio risk over time. LEND appears to have improved the credit quality of its loans over time, with only 29% of its 2003 loan production at a score under 600, compared to 31% in 2002 and 38% in 2001. Management also reduced the delinquency rate (over 30 days) of its serviced portfolio to 1.4% at 3/31/04, compared to 1.8% at 12/31/03 and 2.7% at 12/31/02. Similarly, annual losses as a percentage of average monthly servicing portfolio declined to 0.4% in Q104, from 0.6% in 2003 and 0.9% in 2002. The above loss statistics are not altogether

meaningful, however, as they are skewed by LEND's accelerated origination volume growth which results in a relatively younger portfolio age, and therefore a lower delinquency rate. To better show improved trends at LEND, we compared LEND's loss experience by vintage. As of March 31, 2004, the cumulative net losses 38 months after origination totaled 2.42% for vintage 1999 loans, 2.09% for vintage 2000 loans and 0.65% for vintage 2001 loans.

In further support of the improvements at LEND, on May 27, 2004, Fitch Ratings upgraded LEND's residential primary servicer rating for subprime product to 'RPS3' from 'RPS3-'. "The rating reflects Accredited's successful efforts in maintaining its effective loan portfolio performance while expanding the portfolio, enhancing the senior servicing management team with the addition of a highly experienced head of servicing operations, improving operational efficiencies in loan administration and default management practices, augmenting technology, and widening the scope of both its internal audit and training programs."

5. Current leverage ratio of 16x is on the high end of peer range, however, management intends to remedy this through a future equity raise.

Leverage becomes a greater concern given the increased on-balance sheet debt through securitization. LEND's debt to equity of 16x is on the high end of the peer universe, which averages about 12x. However, to address this leverage concern, management has indicated it will maintain a leverage ratio under 15x and intends to do so through a non-dilutive equity offering later this year. Accordingly, our model assumes a preferred stock offering for \$50M during 3Q04 and another \$50M offering during 1Q05. This brings the leverage ratio to roughly 15x for most of 2004 and 2005.

6. Open capital markets provide LEND with liquidity to fund originations and a market for loan dispositions/securitizations.

LEND's business model depends on its ability to finance and acquire mortgages and to resell/securitize them at a profit. LEND uses funding provided by short-term lines of credit to originate and hold loans until it has aggregated a sufficient quantity of loans to package and sell. As of March 31, 2004, LEND had total capacity of \$2.8B from eight different warehouse lenders.

For whole loan sales, LEND generally sells its loans through a bidding process and enters into forward sales contracts that provide a known outlet and pricing for specified volume of loans that meet specified characteristics. Loans are usually sold on a non-recourse basis, but LEND is obligated to repurchase any loan that materially violates standard mortgage industry reps and warranties. Although the risk of loss resides with the buyer, loan originators are still highly motivated to

produce high quality loans. If loans do not ultimately perform, the originator's funding will likely be threatened as buyers require higher returns (thus increasing the cost to the originator), or may stop buying loans from a particular originator entirely. Therefore, originators are incentivized to produce high quality loans regardless of whether it holds or sells its portfolio.

Management indicates that the demand for securitization remains strong. LEND's continued access to the whole loan and securitization markets is indicative of the market demand as well as of the quality of its loan portfolio. Furthermore, LEND's recurring pool of top-tier trading partners is a testament to its track record as a high quality originator. In 2002, 2003 and Q12004, Household, Morgan Stanley and CSFB consistently represented the top three loan portfolio investors. During those periods, other repeat investors included Lehman Brothers, Goldman, Sachs & Co., Bank of America, GMAC/RFC and Countrywide. During 1Q04, LEND transacted with 17 different trading partners.

LEND continues to reduce its dependence on any one type of loan purchasers. Lend currently sells to four different categories of buyers: 1) large financial services companies that have the ability to issue commercial paper and medium term notes to finance their portfolio acquisition; 2) deposit-based banks who do not represent the asset-backed market, 3) non-Wall Street mortgage banks committed to the asset class who want to service the portfolio and want the credit risk, and 4) Wall Street investment banks that securitize. Each of these categories has been and remains active. According to management, LEND continues to be sought out for the superior quality of its loans.

7. REIT Conversion

We surmise that LEND shares also traded down as a result of management's announcement that it will hold off on making a decision regarding corporate conversion to a REIT structure until 2005. Management cited widely divergent advice regarding structural as well as valuation implications, as well as the significant administrative complexity a REIT conversion would add. Management therefore decided to see how its peers trade subsequent to conversion before taking the leap.

8. Downside Risks

A. *Dramatic increase in interest rates.* As we have previously discussed, the non-prime market is less sensitive to interest rate changes and should therefore be less vulnerable to interest rate increases. However, a significant interest rate increase (200 to 300 bps) over a short timeframe (30 to 60 days) could pose a significant shock to economy and would obviously negatively impact non-prime

loan volume as well as well as increase the cost of hedging. Barring such an event, we think the non-prime market should be resilient in the face of measured interest rate increases. Furthermore, we have factored in decelerating originations growth and lower loan sale premiums into our earnings estimates.

B. *Economic weakness.* Continued economic weakness could negatively impact housing prices, increasing LEND's average LTV, and decreasing the homeowners' borrowing capacity. Higher unemployment rates and lower consumer income could increase delinquency rates and therefore potential losses. On the other hand, an economic downturn could also create a larger pool of credit-impaired borrowers.

C. *Regional concentration risk.* During 1Q04, 31% of LEND's loan volume was generated from California (CA). However, by virtue of the relative size of CA's economy, it appears that having CA as the largest concentration of its portfolio is not unusual. About a dozen of LEND's competitors also have significant geographic concentration in CA. Considering that the average concentration in CA, LEND's 31% concentration in California is actually on the lower end of the range. There is a risk to LEND if real estate values in CA were to decline dramatically, as certain areas of California are considered to be overheated. Declining property values in other regions could also limit the amount borrowers can borrow against. However, this risk is mitigated by LEND's geographic expansion into all 50 states. Management noted that in the last century, there has only been one national real estate decline, and that was during the great depression. According to the chief economist for the National Association of Realtors, David Lereah, "U.S. house prices have never ended a year with a nationwide decline since the data were first collected in 1978, and are not about to fall now." While we agree that the most recent 25 years probably do not provide enough evidence that housing prices will not experience a significant decline, we note that the government has a major interest in preventing such a decline, which we think mitigates, but does not eliminate the risk.

D. *Regulatory risk and "anti-predatory lending" legislation.* The mortgage lending industry is highly regulated by local, state and federal laws. However, LEND's technology and controls are set up to comply with the specific rules and regulations for the areas they operate in. Furthermore, many states and cities have passed or are considering regulations against predatory lending practices. While LEND adopts conservative lending practices (avoids generating "high cost" loans) to avoid this inference, additional legislation in this area could limit LEND from charging prepayment penalties, thereby limiting profitability. While some states have gone to extremes, the regulations within many jurisdictions have remained within reason. For example, LEND still has prepayment penalties on over 90% of its loans. However, the current trend is toward more legislation. Some states have

passed predatory-lending laws that are so strict that lenders have stopped operating in those states/states (GA, NY, DC, Oakland). Some states/cities, having realized that they have may have overreached, have reversed some of their restrictions, after lenders discontinued doing business in their jurisdictions. Also, the industry has initiated a significant lobbying effort for a national pre-emptive legislation that would stop states/cities from making vague or overreaching laws. Although it is difficult to predict the course that the regulatory environment will take, LEND is relatively well positioned to address this risk as it operates in the higher range of the non-prime market, and is geographically well diversified.

E. *Significant competition.* Bears contend that this is a highly competitive, low barrier-to-entry business. In the last few years, Fannie Mae and Freddie Mac (GSEs) have begun to purchase non-prime residential loans. Increased penetration in the non-prime market by these GSEs could change the dynamics of the industry by virtue of their size and pricing power. In addition, as a result of their purchasing practices, these GSEs have experienced higher-than-expected losses. Such experience could taint the overall investor perception on the non-prime industry. An even greater concern, however, is irrational pricing practices by competitors vying for volume in a declining market, which could jeopardize industry margins.

9. Financial Assumptions

Management raised its 2Q04 EPS guidance to \$1.50-\$1.60 from \$1.25-\$1.35 and its FY2004 EPS guidance to \$5.30-\$5.60 from \$5.00-\$5.25, due to expected hedging gains.

We estimate LEND will originate approximately \$10.5B of loans in 2004. LEND originated \$2.4B during Q104, which is typically the slowest quarter of the year. Management has guided to this expectation for 2004 as well, barring some unforeseen circumstances in the marketplace.

During 2003, 1Q volume represented 18% of totally volume for the year. If we use 1Q03 volume as a proxy for the seasonality factor, this implies that the 42.4B generated during 1Q04 could result in total 2004 volume of \$13.3M. We therefore think our estimate of \$10.5B is conservative. We assume a decelerating growth rate for 2005, and increase originations by 5.6% to \$11.1B.

Our estimates assume that LEND will retain its market share of 2.4% and increase its market share to 3.0% during 2005. Historically, LEND has grown its market share from 1.5% in 2001 to 2.0% in 2002 and 2.4% in 2003. We think that because LEND still has a very small share of the market, can feasibly increase market share minimally without getting noticed by its larger competitors.

We assume LEND sells 70% of its loan production in 1Q04, which gradually declines to 67% for all of 2005. Net gains on these sales are estimated to be 4.00% for 2Q04 due to hedging gains, and is therefore estimated to decline to 3.35% by the end of 2005.

The average earning assets is estimated to be \$4.7B and \$7.3B for 2004 and 2005, respectively. We have assumed the interest income spread to be 4.55% in 2Q04, decreasing to 4.00% by the end of 2005.

The allowance for losses is expected to be 1% in 2Q04, and increasing to 1.15% by the end of 2005.

LEND's servicing portfolio is estimated to average \$5.2B in 2004 and \$7.4B in 2005, generating annualized fees of 16 bps.

We have assumed preferred equity offerings of \$50M during both 3Q04 and 1Q05. This will maintain leverage ratio of about 15x as guided by management. We are assuming a 9% yield on the preferred equity.

We estimate fully diluted EPS of \$1.54 for 2Q04, \$5.38 for 2004 and \$5.78 for 2005 (representing net margins of 1.1% of originations for both 2004 and 2005).

10. Valuation

Considering the risks described previously, and even after the 12% rally over the last three trading days, we think that LEND shares still trade at a significant discount and provide attractive upside potential. With consensus EPS for LEND at \$5.47 for FY2004 and \$5.87 for FY2005, LEND is currently trading at a mere 5.0x FY2004 Consensus EPS. LEND shares have been affected by perceived vulnerability to interest rate risk, and the decision to hold off on a corporate REIT conversion. We think LEND will continue to deliver strong origination volume and a growing balance sheet portfolio, and its shares should strengthen as a result.

Even assuming minimal origination volume growth in 2005 (5.6%) and lower whole loan sale premium and interest income spread, we think that LEND will continue to generate earnings growth, and will eventually realize a multiple expansion. We estimate EPS to be \$5.38 for FY2004 and \$5.78 for FY2005 (growth rate of 7.5%). We think our estimates are conservative. Based on the 2005 P/E multiple of LEND's comparable universe, we think a multiple of 7.0x is appropriate. LEND's non-prime peers are trading at a mean FY2005 EPS multiple of 7.0x and a median multiple of 7.3x (NCEN, SAXN, NDE, CFC). Applying a

7.0x multiple to our estimated 2005 EPS of \$5.78 results in a target price of \$40.00. We are therefore setting a 12-month price target of \$40.00, a potential 37% upside.

11. Projections:

\$000s	1Q04a	2Q04e	3Q04e	4Q04e	1Q05e	2Q05e	3Q05e	4Q05e
Interest Income	60,626	76,093	87,287	100,703	112,697	124,648	135,597	147,700
Gain on Sale of Loan	54,730	69,713	68,625	67,765	64,230	60,990	64,822	63,907
Loan Servicing Inc.	1,563	1,839	2,073	2,332	2,590	2,829	3,066	3,308
Net Gain on Secs.	1,842	0	0	0	0	0	0	0
Other Income	202	200	200	200	200	200	200	200
Total Revenue	118,963	147,845	158,185	170,999	179,716	188,667	203,686	215,115
Salaries/Wages	35,394	37,089	41,164	42,424	41,085	39,578	42,684	42,709
Interest Expense	20,930	25,841	31,602	38,800	45,107	52,404	58,329	65,360
Occupancy	3,853	4,027	4,420	4,556	4,656	4,749	5,407	5,695
Provision for Losses	7,449	10,870	13,716	15,602	18,254	20,048	21,809	23,591
Depreciation/Amort.	1,774	1,973	2,141	2,323	2,520	2,735	2,967	3,219
General/Admin.	12,053	12,597	13,981	14,409	14,243	13,984	15,366	15,945
Total Oper Expense	81,453	92,397	107,025	118,113	125,866	133,498	146,562	156,519
Net Inc Before Taxes	37,510	55,448	51,160	52,886	53,851	55,169	57,124	58,596
Income Taxes	15,004	22,179	20,464	21,154	21,540	22,068	22,850	23,439
Net Income After Taxes	22,506	33,269	30,696	31,732	32,310	33,101	34,275	35,158
Preferred Dividend	0	0	1,125	1,125	2,250	2,250	2,250	2,250
Net Income to Common	22,506	33,269	29,571	30,607	30,060	30,851	32,025	32,908
Basic Shares	20,119	20,169	20,219	20,269	20,319	20,369	20,419	20,469
Basic EPS	1.12	1.65	1.46	1.51	1.48	1.51	1.57	1.61
Diluted Shares	21,504	21,554	21,604	21,654	21,704	21,754	21,804	21,854
Diluted EPS	1.05	1.54	1.37	1.41	1.39	1.42	1.47	1.51

Y/Y Change	1Q04a	2Q04e	3Q04e	4Q04e	1Q05e	2Q05e	3Q05e	4Q05e
Interest Income	87.7%	88.7%	82.3%	72.1%	85.9%	63.8%	55.3%	46.7%
Gain on Sale of Loan	26.8%	10.8%	5.2%	-2.9%	17.4%	-12.5%	-5.5%	-5.7%
Loan Servicing Inc.	-17.0%	-4.6%	4.8%	25.6%	65.7%	53.9%	47.9%	41.9%
Net Gain on Secs.	31.7%	-100.0%	-100.0%	-100.0%	-100.0%	na	na	na
Other Income	-48.3%	112.8%	104.1%	0.5%	-1.0%	0.0%	0.0%	0.0%
Total Revenue	50.3%	36.6%	36.1%	29.9%	51.1%	27.6%	28.8%	25.8%
Salaries/Wages	48.3%	37.8%	43.4%	29.7%	16.1%	6.7%	3.7%	0.7%
Interest Expense	72.0%	74.1%	90.2%	94.6%	115.5%	102.8%	84.6%	68.5%
Occupancy	63.5%	60.6%	42.5%	39.7%	20.8%	17.9%	22.3%	25.0%
Provision for Losses	14.5%	10.1%	109.8%	52.8%	145.0%	84.4%	59.0%	51.2%
Depreciation/Amort.	58.8%	104.3%	69.9%	53.7%	42.1%	38.6%	38.6%	38.6%
General/Admin.	42.8%	23.9%	27.8%	1.8%	18.2%	11.0%	9.9%	10.7%
Total Oper Expense	49.6%	41.6%	59.4%	44.4%	54.5%	44.5%	36.9%	32.5%
Net Inc Before Taxes	52.0%	29.0%	4.2%	6.1%	43.6%	-0.5%	11.7%	10.8%
Income Taxes	52.0%	29.0%	4.2%	6.6%	43.6%	-0.5%	11.7%	10.8%
Net Income After Taxes	52.0%	29.0%	4.2%	5.9%	43.6%	-0.5%	11.7%	10.8%
Preferred Dividend	na	na	na	na	na	na	100.0%	100.0%
Net Income to Common	52.0%	29.0%	0.4%	2.1%	33.6%	-7.3%	8.3%	7.5%
Basic Shares	61.7%	4.7%	2.9%	2.1%	1.0%	1.0%	1.0%	1.0%
Basic EPS	-5.9%	23.1%	-2.5%	0.0%	32.1%	-8.2%	7.2%	6.5%
Diluted Shares	23.5%	4.4%	2.7%	1.9%	0.9%	0.9%	0.9%	0.9%
Diluted EPS	23.5%	23.5%	-2.2%	0.2%	31.9%	-8.1%	7.3%	6.5%

% of Total Revenue	1Q04a	2Q04e	3Q04e	4Q04e	1Q05e	2Q05e	3Q05e	4Q05e
Interest Income	51.0%	51.5%	55.2%	58.9%	62.7%	66.1%	66.6%	68.7%
Gain on Sale of Loan	46.0%	47.2%	43.4%	39.6%	35.7%	32.3%	31.8%	29.7%
Loan Servicing Inc.	1.3%	1.2%	1.3%	1.4%	1.4%	1.5%	1.5%	1.5%
Net Gain on Secs.	1.5%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Other Income	0.2%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Total Revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Salaries/Wages	29.8%	25.1%	26.0%	24.8%	22.9%	21.0%	21.0%	19.9%
Interest Expense	17.6%	17.5%	20.0%	22.7%	25.1%	27.8%	28.6%	30.4%
Occupancy	3.2%	2.7%	2.8%	2.7%	2.6%	2.5%	2.7%	2.6%
Provision for Losses	6.3%	7.4%	8.7%	9.1%	10.2%	10.6%	10.7%	11.0%
Depreciation/Amort.	1.5%	1.3%	1.4%	1.4%	1.4%	1.4%	1.5%	1.5%
General/Admin.	10.1%	8.5%	8.8%	8.4%	7.9%	7.4%	7.5%	7.4%
Total Oper Expense	68.5%	62.5%	67.7%	69.1%	70.0%	70.8%	72.0%	72.8%
Net Inc Before Taxes	31.5%	37.5%	32.3%	30.9%	30.0%	29.2%	28.0%	27.2%
Income Taxes	12.6%	15.0%	12.9%	12.4%	12.0%	11.7%	11.2%	10.9%
Net Income After Taxes	18.9%	22.5%	19.4%	18.6%	18.0%	17.5%	16.8%	16.3%
Preferred Dividend	0.0%	0.0%	0.7%	0.7%	1.3%	1.2%	1.1%	1.0%
Net Income to Common	18.9%	22.5%	18.7%	17.9%	16.7%	16.4%	15.7%	15.3%

\$000s	FY2003a	FY2004e	FY2005e
Interest Income	178,982	324,708	520,642
Gain on Sale of Loan	241,115	260,834	253,949
Loan Servicing Inc.	7,645	7,807	11,793
Net Gain on Secs.	6,698	1,842	0
Other Income	782	802	800
Total Revenue	435,222	595,993	787,184
Salaries/Wages	112,239	156,071	166,056
Interest Expense	63,562	117,173	221,200
Occupancy	11,225	16,856	20,507
Provision for Losses	33,129	47,638	83,702
Depreciation/Amort.	4,854	8,211	11,441
General/Admin.	43,651	53,039	59,538
Total Operating Expense	268,660	398,988	562,444
Net Income Before Taxes	166,562	197,005	224,740
Provision for Income Taxes	66,547	78,802	89,896
Net Income After Taxes	100,015	118,203	134,844
Preferred Dividend	0	2,250	9,000
Net Inc to Common Shareholders	100,015	115,953	125,844
Basic Weighted Average Shares	17,825	20,194	20,394
Basic EPS	5.61	5.74	6.17
Diluted Weighted Average Shares	20,108	21,579	21,779
Diluted EPS	4.97	5.38	5.78

Y/Y Change	FY2003a	FY2004e	FY2005e
Interest Income	163.7%	81.4%	60.3%
Gain on Sale of Loan	96.2%	8.2%	-2.6%
Loan Servicing Inc.	-8.7%	2.1%	51.1%
Net Gain on Secs.	480.4%	-72.5%	-100.0%
Other Income	51.6%	2.6%	-0.2%
Total Revenue	116.8%	36.9%	32.1%
Salaries/Wages	50.5%	39.1%	6.4%
Interest Expense	127.9%	84.3%	88.8%
Occupancy	61.5%	50.2%	21.7%
Provision for Losses	87.5%	43.8%	75.7%
Depreciation/Amort.	87.1%	69.2%	39.3%
General/Admin.	88.9%	21.5%	12.3%
Total Operating Expense	75.8%	48.5%	41.0%
Net Income Before Taxes	247.0%	18.3%	14.1%
Provision for Income Taxes	246.6%	18.4%	14.1%
Net Income After Taxes	247.3%	18.2%	14.1%
Preferred Dividend	na	na	300.0%
Net Inc to Common Shareholders	247.3%	15.9%	8.5%
Basic Weighted Average Shares	208.6%	13.3%	1.0%
Basic EPS	12.4%	2.4%	7.5%
Diluted Weighted Average Shares	37.5%	7.3%	0.9%
Diluted EPS	151.0%	8.2%	7.5%

<u>% of Total Revenue</u>	<u>FY2003a</u>	<u>FY2004e</u>	<u>FY2005e</u>
Interest Income	41.1%	54.5%	66.1%
Gain on Sale of Loan	55.4%	43.8%	32.3%
Loan Servicing Inc.	1.8%	1.3%	1.5%
Net Gain on Secs.	1.5%	0.3%	0.0%
Other Income	0.2%	0.1%	0.1%
Total Revenue	100.0%	100.0%	100.0%
Salaries/Wages	25.8%	26.2%	21.1%
Interest Expense	14.6%	19.7%	28.1%
Occupancy	2.6%	2.8%	2.6%
Provision for Losses	7.6%	8.0%	10.6%
Depreciation/Amort.	1.1%	1.4%	1.5%
General/Admin.	10.0%	8.9%	7.6%
Total Operating Expense	61.7%	66.9%	71.5%
Net Income Before Taxes	38.3%	33.1%	28.5%
Provision for Income Taxes	15.3%	13.2%	11.4%
Net Income After Taxes	23.0%	19.8%	17.1%
Preferred Dividend	0.0%	0.4%	1.1%
Net Inc to Common Shareholders	23.0%	19.5%	16.0%