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New Rec: IndyMac Bancorp (NDE: $44.87) April 19, 2006

Position: Sell **Target: $33**

	1Q06e	2Q06e	3Q06e	4Q06e	FY2006e	FY2007e
Rev ($000s)	272.6	283.1	281.8	285.3	1,122.8	1,126.0
EPS ($)	1.03	1.06	1.03	0.99	4.12	3.57
Y/Y Growth	2.2%	-15.8%	-12.7%	-8.8%	-9.3%	-13.3%
PE	na	na	na	na	10.9	12.6
PSR	na	na	na	na	2.6	2.6
Consensus	1.07	1.20	1.25	1.24	4.78	5.37

Shares Out: 66.0M **Market Cap: $2.96B** **FYE: Dec**

Summary: IndyMac operates as a hybrid thrift/mortgage banker. It generates revenues from both the net income spread of its leveraged balance sheet and from the gain on sale of mortgages it produces and subsequently sells. NDE's mortgage business is concentrated in California (44% of loan production) and the company

specializes in Alt-A mortgages (66% of loan production), which are good quality loans that are not GSE (government sponsored enterprise, i.e. Fannie Mae) conforming, as described below.

NDE's stock price has appreciated 140% over the past three years, from about $18 in early 2003 to today's closing price of $44.87. This performance has been driven by growth in mortgage production and securitization, the related non-cash gain on sale revenue and, consequently, higher earnings. FY2002 to FY2005, NDE's mortgage production has grown from $20.3B to $60.8B, its gain on sale revenue has grown from $300.8M to $592.2M, and its EPS has increased from $2.41 to $4.54. "Street" analysts are enthused by this performance. According to Bloomberg, eight of the twelve analysts that cover NDE have Buy ratings.

The main problem for NDE is the seeming disconnect between the expected decline in US mortgage originations for 2006, due mainly to higher interest rates and a less robust housing market, and NDE's expectations for its own performance. The Mortgage Bankers Association (MBA) forecasts a –14% decline in originations for 2006. Additionally, the Standard & Poor's Ratings Services recently predicted that the Alt-A market for 2006 will be "at or slightly below the 2005 level". Despite these forecasts, NDE expects its mortgage production to grow by 21% this year. How will NDE be able to buck the wider industry trend and grow its business in a declining market?

We think that, in order to achieve this growth, NDE will have to look outside of its traditional origination channels (direct and wholesale mortgage brokers) and will have to purchase an increasing amount of conduit mortgages in the marketplace. Conduit mortgages are loans that have already been originated, closed and funded by other mortgage institutions and which are then sold in bulk. When NDE purchases these loans, it includes them in its mortgage production totals, its production growth and its market share. We think that this purchasing strategy masks the company's true market share and its ability to grow its mortgage production organically.

The bigger problem, as one might expect, is that these purchased conduit mortgages have significantly lower gain on sale margins (0.07% for purchases versus 1.57% for internally generated mortgages in 2005). If conduit mortgages become a larger portion of NDE's total production, as appears likely, the company's total gain on sale margin will be dragged down. The result would likely be disappointing gain on sale revenue, total net revenue and EPS. We expect total net revenues to equal $1.123B in 2006. This is 6.5% below the "street's" $1.201B expectation. Assuming a 10% growth in operating expenses, a 39.5% tax rate and 67.8M average diluted shares outstanding, we estimate 2006

EPS of $4.12. This compares to management's $4.88 guidance and the slightly more cautious $4.78 "street" consensus.

There are additional risks to NDE's business and financial results. Nearly 40% of the company's 2005 net revenue was from net interest income. NDE is forecasting a 2.05% NIM in 2006, down slightly from 2.14% in 2005 but up from 1.98% in 4Q05. Our model gives management the benefit of the doubt on this assumption. However, NDE's cost of funds has been increasing faster than its interest earned. Its NIM has been 2.91%, 2.61%, 2.14% for 2003 through 2005, respectively. If this trend continues, NDE's NIM could be worse than expected in 2006 and lead to further EPS disappointment.

We also think that NDE's balance sheet is becoming more risky. Not only is NDE growing its balance sheet via increased leverage, many of its assets (consumer and builder construction loans) may contain more credit risk than assumed if the housing market softens. The fact that these loans are highly concentrated (approximately 50%) in California adds to this risk.

NDE's use of non-cash gain on sale accounting boosts near-term earnings, but not cash flow and, in our opinion, results in poor quality of earnings. We estimate that NDE's 2005 FCF, excluding changes in working capital and activity from trading securities and purchasing loans, was negative, -$74.7M. Additionally, the gain on sale amount is driven by the MSR (mortgage service rights) valuation, which is relies on management's assumptions for prepayments and the discount rate. Changes or inaccuracies in these assumptions can have a significant effect on the company's financial results.

If our thesis is correct, we expect that the "street" optimism surrounding NDE's growth prospects will be replaced by concerns of a declining mortgage origination market, lower gain on sale margins and disappointing revenues and earnings. Our initial $33 price target is based on an 8x PE multiple (equivalent to the average forward 12 month multiple for six comparable mortgage banking companies) on 2006 EPS of $4.12. Additional downside may exist. In early 2003, the stock traded as low as 6.7x on forward earnings, when sentiment regarding mortgage originations was negative. This would equate to $28 per share based on our 2006 estimates. Also, it is not unusual for mortgage banking stocks to trade at book value, as NDE did in both 1998 and 1999. NDE's current book value is $23 per share.

The company reports its 1Q06 results on April 25. While we model a slight EPS miss in the quarter, we are close to consensus, and there is a chance that NDE will beat expectations in the near term.

Background:

IndyMac Bancorp is the holding company for IndyMac Bank, which is based in Pasadena, CA. IndyMac Bank is the 9th largest savings and loan nationwide based on assets, the 9th largest residential mortgage originator in the US, and the largest S&L in Los Angeles county, CA.

The company began operations in 1985 as a passive mortgage REIT, under the name Countrywide Mortgage Investments. In 1993, NDE became an active mortgage originator. In 2000, NDE terminated its REIT status and acquired SGV Bancorp, a federal savings and loan institution, and renamed itself IndyMac Bank.

NDE currently operates under two business segments, thrift and mortgage. Revenues from its thrift business consist primarily of net interest income, representing the spread between the interest earned on its investments in single-family residential (SFR) mortgage assets (such as MBS securities, mortgages and construction loans) and its cost of funds (from deposits and borrowings).

Mortgage revenue consists primarily of the gain on sale from securitized mortgage pools, sales to GSEs, or whole loan sales. NDE securitizes and/or sells its mortgages after an average of 52 days from the date of origination. There are several ways in which NDE segments its mortgage origination data, i.e. product type, amortization type, origination channel, geographic distribution.

By product type, Alt-A mortgages comprised 66% of total mortgage production in 2005. These mortgages are generally considered high quality but, for various reasons, they do not comply with the GSEs' (i.e. Fannie Mae) criteria for a conforming mortgage. The most common reasons for non-compliance are 1) lack of full documentation (no verified income or assets), 2) exceeding the loan size limit (currently $417k) and 3) loan is used to purchase a second home. According to some industry experts, the demand for Alt-A has been driven by an increased demand for second homes plus the desire for a more streamlined application process.

Table 1
NDE Loan Production by Product Type
($Ms)

	2002	2003	2004	2005
Alt-A	8,515	15,496	24,312	40,117
Jumbo	4,223	3,727	1,995	1,987
Agency Conforming	4,180	5,096	1,867	1,092
Subprime	1,379	1,855	2,244	2,276
Subprime Expanded	0	0	1,405	5,119
HELOC	401	932	2,393	3,653
Reverse	0	0	893	2,935
Consumer construction	1,578	2,130	2,793	3,595
Total mortgage production	20,276	29,236	37,902	60,774
Builder construction	606	800	1,146	1,940
Warehouse lending	0	0	0	201
Total production	20,882	30,036	39,048	62,915

Source: Company information

By amortization type, just 28% of the company's mortgages were fixed rate in 2005. The remaining 72% were adjustable-rate mortgages of different types, as shown in Table 2.

Table 2
NDE Loan Production by Amortization Type
(%)

	2004	2005
Fixed rate	32	28
Option ARMs	21	29
ARMs and Hybrid ARMs	24	19
Hybrid ARMs Interest Only	23	24

Source: Company 10-Ks

Table 3 shows mortgage production by origination channel. NDE's wholesale/correspondent channel created more than 1/2 of the company's mortgage production in 2005. We note that wholesale itself produced $29,145M or 48% and correspondent produced the remaining $5,719M or 9%.

Wholesale mortgages are loans funded by NDE but generated by third-party mortgage brokers with whom NDE has non-exclusive relationships. Correspondent mortgages are originated, funded and closed by another mortgage institution and subsequently purchased by NDE on a flow basis. Conduit mortgages are bulk purchases by NDE from other financial institutions that had already originated, funded and closed the loan. In this report, we refer to "internally" generated mortgages, which excludes purchased (correspondent and conduit) loans but includes wholesale and NDE-generated mortgages. Consumer direct mortgages are originated via NDE's retail branches, direct mail, internet sites or other direct means. NDE acquired Financial Freedom in 2004 and is currently the leading provider of reverse mortgages in the US. Reverse mortgages allow homeowners over the age of 62 to convert home equity into cash payments, either by lump sum, monthly payments or as a credit line. Consumer construction loans are 6-12 month financings of new home construction by consumers. Upon completion of the construction, the loan usually converts to a SFR mortgage.

Table 3
NDE Loan Production by
Origination Channel
($Ms)

	2004	2005	2005 % of Total
Wholesale/Correspondent	21,519	34,864	57.4%
Conduit	7,653	15,811	26.0%
Consumer Direct	4,036	2,884	4.7%
Financial Freedom	893	2,935	4.8%
Consumer Construction	2,238	2,994	4.9%
Total Mortgage Production	37,903	60,775	100.0%

Source: Company 10-K

The company's loan production is heavily concentrated in California, as Table 4 shows. This geographic risk is discussed below.

Table 4
Geographic distribution of
NDE's loan production

	2005
California	44%
Florida	8%
New York	6%
Virginia	4%
New Jersey	4%
Other	34%

Source: Company 10-K

The Mortgage Bankers Association estimates that there was $2.755T of mortgage originations in the US in 2005. The sub-sector Alt-A mortgage market, in which NDE specializes, had approximately $330M in originations in 2005, according to Inside Mortgage Finance, a publisher of industry data. The market shares for the Alt-A marketplace are shown in the table below.

Table 5
2005 Alt-A Mortgage Market Shares

	Originations ($B)	Market share
1. Countrywide	$63.0	19.1%
2. IndyMac	$44.5	13.5%
3. Aurora (Lehman)	$39.9	12.1%
4. GMAC	$34.5	10.5%
5. Wells Fargo	$30.0	9.1%
6. Impac	$22.0	6.7%
7. North Fork	$18.4	5.6%
8. WMC (GE)	$17.1	5.4%
9. First Horizon	$10.3	3.1%
10. SunTrust	$8.7	2.6%
Total	$330.0	100.0%

Source: Inside Mortgage Finance

There are a few accounting terms that we refer to in our report that we summarize here. "Mortgage Service Rights" (MSRs) are assets created upon the sale of loans when the servicing of those loans is retained by NDE. MSRs represent the estimated present value of future cash flows to be received by NDE for servicing the sold loans. MSR valuations rely on management's estimates for prepayments and the discount rate.

NDE uses "gain on sale" accounting when it sells its mortgages. Gain on sale revenue is the excess of cash proceeds from the sold mortgages plus MSRs created upon sale (and the present value of any additional retained interests) over the book value of the mortgages sold. The gain on sale is primarily a non-cash benefit to revenues and earnings. "Gain on sale margin" divides the gain on sale by the total value of loans sold.

"Mortgage banking revenue" (MBR) is the gain on sale for mortgages sold plus the net interest income of loans held for sale. The "MBR margin" is calculated by dividing the MBR by the total value of loans sold.

Discussion:

1. The Mortgage Bankers Association (MBA) currently forecasts a -14% decline in mortgage originations for 2006. Yet, NDE expects to grow its mortgage production by 21%.

The MBA is forecasting total mortgage originations of $2.365T in 2006 in the US, down 14% from $2.755T in 2005. Higher mortgage rates and a softening of the housing market are the primary reasons for the decline. The higher rates are expected to have an especially negative impact on the amount of refinances that occur. Table 5 shows that refinances made up 46% of all mortgage originations in 2005 and purchases generated the other 54%. The MBA expects refinances to decline -28% in 2006 and purchases to decline -2%, for a blended decrease of –14%.

Table 6
U.S. Mortgage Production
($billions)

	2004	2005	2006E	2007E
Total Industry Production	2,772	2,755	2,365	2,280
y/y % change		-0.6%	**-14.2%**	-3.6%
Industry Purchases	1,309	1,476	1,444	1,471
y/y % change		12.8%	**-2.2%**	1.9%
Industry Refinances	1,463	1,279	921	810
y/y % change		-12.6%	**-28.0%**	-12.1%
Refinances Share of Total	52.8%	46.4%	38.9%	35.5%

Source: Mortgage Bankers Association

The expected decline in refinances may have a greater impact on NDE as compared to the industry average. This is due to the fact that NDE's 2005 mortgage production consisted of a greater proportion of refinances, 58% refinances and 42% purchases. Using the MBA's forecasted declines for each segment, we calculate an expected decline of –17% in NDE's mortgage production for 2006. This initial estimate assumes that NDE's mortgage production exactly mirrors the MBA's industry expectations, which we concede will likely not be exactly the case.

Table 7
NDE Mortgage Production assuming
MBA forecasted growth rates for
Purchase and Refinance segments
($billions)

	2004	2005	2006E	2007E
Total Production	37.9	60.8	50.4	47.8
y/y % change		60.4%	-17.1%	-5.1%
Purchases	16.1	25.6	25.0	25.5
y/y % change		59.0%	-2.2%	1.9%
Refinances	21.8	35.2	25.3	22.3
y/y % change		61.5%	-28.0%	-12.1%
Refinance Share of Total	57.5%	57.9%	50.3%	46.6%

Source: Company info, MBA forecasts, OWS estimates

Given the increasing popularity and penetration of Alt-A mortgages in the marketplace, and given that 66% of NDE's 2005 mortgages were Alt-A, we think it is prudent to expect NDE to perform somewhat better than the MBA's general industry forecast. In fact, the Standard & Poor's Ratings Services recently predicted that the Alt-A market for 2006 will be "at or slightly below the 2005 level".

If we assume that NDE's Alt-A mortgage production, 66% of the total, is flat in 2006 versus 2005, and that the remaining 34% of NDE's mortgage production declines by –17%, as the MBA forecast would predict, we would calculate a –6% decline in total mortgage production for NDE in 2006. We do not use the -6%decline in our projections, but, instead, conservatively model a 0% change in NDE's 2006 mortgage production generated internally.

In sharp contrast to what one might expect from the above numbers, management's guidance is for 21% growth in mortgage production, from $60.8M in 2005 to $73.8M in 2006. There is a large dichotomy between this guidance and what we might expect using the MBA forecast, or even our more conservative expectation of flat production generated internally.

2. We wonder, if industry-wide expectations are generally correct, how can NDE grow its mortgage production by 21% in 2006? In our opinion, NDE would likely look outside of its traditional internally-generated origination channels and would purchase already existing mortgages from other originators in the marketplace. As it has done in recent years, the company would include these purchased mortgages in its total production results, which could allow it to meet its production goals.

This purchasing strategy would mask the company's true market share and its ability to grow its mortgage production internally. In 2005, NDE reported $21.5B in mortgages purchased through correspondent and conduit channels, 35% of NDE's total mortgage production. Excluding these purchased mortgages, the company produced $39.2B in mortgages internally, which equates to a 1.42% market share. This is significantly below the 2.19% market share quoted by NDE, which includes purchased mortgages. Likewise, we estimate that NDE grew its mortgage production by 37% internally, 2006 versus 2005. This is an impressive growth rate, but far below the 60% reported when the company includes its purchased mortgages.

In order to achieve its 21% mortgage production goal, we estimate that NDE will have to increase its conduit purchases by 82% y/y, from $15.8B in 2005 to $28.7B in 2006. As stated above, we forecast internally generated mortgages to be flat year over year at about $39.2B. We expect the company's correspondent purchases to also remain flat at $5.7B. Correspondent purchases are difficult to analyze or to forecast due to inconsistent disclosures by the company, in our opinion. Our expectation of $34.4B in total mortgage purchases would comprise nearly 47% of NDE's total mortgage production.

3. The problem is that these purchased mortgages generate significantly lower gain on sale and MBR margins. We expect that as NDE becomes more reliant on purchasing conduit mortgages for production growth, the lower associated margins will lead to disappointing financial results.

We estimate that NDE realized a gain on sale margin for its conduit mortgages of just 0.07% in 2005. That is, for every $100M of conduit loans that the company securitizes, NDE recognizes just $70k of gain on sale revenue. As Table 8 shows, this margin is far below the 1.57% gain on sale margin experienced for mortgages originated internally. Similarly, we estimate that conduit mortgages produced an MBR margin of just 0.41% in 2005. This compares to a 1.74% MBR margin for mortgages originated internally.

Table 8
2005 Mortgage Origination Sources
($Ms)

	Loans Sold	Gain on Sale	Gain on Sale Margin	NII of Loans Held for Sale	Total MBR	MBR Margin
Wholesale	28,359	394,498	**1.39%**	51,409	445,907	**1.57%**
Consumer Direct	2,852	59,260	**2.08%**	5,699	64,959	**2.28%**
Financial Freedom	2,829	80,262	**2.84%**	2,880	83,142	**2.94%**
Total Internal Production	34,040	534,020	**1.57%**	59,988	534,020	**1.74%**
Correspondent	5,425	48,235	**0.89%**	11,229	59,464	**1.10%**
Conduit	14,819	9,974	**0.07%**	51,285	61,259	**0.41%**

Source: Company information, OWS estimates

It is not surprising that conduit mortgages have very low margins. The company is purchasing and selling assets in a highly liquid, highly competitive and very efficient market place. In our opinion, the implementation of what basically amounts to a buy and sell trading strategy of mortgages should not result in any meaningful gain on sale profit.

As explained above, we expect NDE to become more reliant on purchasing mortgages to meet its production guidance and to grow its market share. As the low margin conduit mortgages become a greater percentage of the company's total production, we would expect the total company gain on sale margin and MBR margin to decrease. Our estimate for NDE's 2006 gain on sale margin is 0.74%. This compares to 1.13% in 2005. Management does not provide specific guidance for gain on sale margins. Our estimate for NDE's 2006 MBR margin (driven primarily by the lower gain on sale margin) is 0.98% versus management's guidance of 1.20%. The company's 2005 MBR margin was 1.37%.

We forecast $482.5M in gain on sale revenue in 2006, down –18.5% from $592.2M in 2005, due to the lower gain on sale margins. Our total net revenue estimate for 2006 is $1,123M, 6.5% below the "street's" expectation of $1,201M. We estimate $4.12 in 2006 EPS, below the "street" consensus of $4.78. The bottom line is that we expect NDE's increasing reliance on lower margin conduit mortgages to result in disappointing net revenues and earnings in 2006.

4. NDE is guiding to a net interest margin of 2.05%, down slightly from 2.14% in 2005. However, if the yield curve becomes increasingly inverted, NDE's reinvestment spreads and NIM could narrow more than expected.

For now, we are giving management the benefit of the doubt on its NIM guidance for 2006 and our model incorporates its 2.05% NIM expectation. Since 2003, NDE has experienced a continuous decline in its NIM as its cost of funds has risen more rapidly than its interest earned on assets held. The company's NIM has declined from 2.91% in 2003, to 2.61% in 2004, to 2.14% in 2005. If this downward trend were to continue at the same rate, we would expect NDE's NIM to decline another 30-40 bps in 2006 to approximately 1.80 bps. Such a NIM would produce additional disappointment on the company's top line and bottom line. In fact, a 1.80% NIM would reduce our estimated 2006 net interest income by about $62M and lower our estimated EPS to $3.56.

Table 9
Net Interest Margin

	2003	2004	2005	2006E	2007E
Total interest earning assets	5.39%	4.95%	5.44%	6.39%	6.75%
Total interest-bearing liabilities	2.74%	2.48%	3.49%	4.56%	4.88%
Net interest spread	2.66%	2.47%	1.95%	1.83%	1.87%
Net interest margin	2.91%	2.61%	2.14%	2.05%	2.05%

Source: NDE 10-K, OWS estimates

5. NDE's balance sheet is becoming more leveraged and more highly concentrated in construction loans that may prove to be risky in a softening housing market.

The company's average annual balance sheet has nearly tripled in the past three years from an average of $7.2B in assets in 2002 to $19.6B in assets in 2005. Greater borrowing has been the primary driver of this growth. While thrift deposits have increased from $2.7B to $5.9B over these three years, borrowings have grown from $3.8B to $12.7B. NDE's debt to equity ratio has increased from 4.5x in 2002 to 9.3x in 2005. Management's guidance for 2006 includes average earning assets of $24.5B, up nearly $5B (25%) from 2005. We expect the majority of this growth to again come from increased borrowing. NDE's primary sources of funding are advances from the Federal Home Loan Bank and repurchase agreements. We will continue to monitor NDE's ability to access additional capital and its cost of capital, in particular its advances from the FHLB. We note that FHLB advances have grown rapidly throughout the industry and these advances appear to be attracting more scrutiny from economists and governmental agencies because they boost mortgage activity and increase the risk in the system.

Of the $8.2B in loans held for investment on NDE's 12/31/05 balance sheet, $1.7B is consumer construction loans and $0.8B is builder construction loans. Whereas NDE's securitized loans generally do not have any recourse to the company, these construction loans are held on the balance sheet and the risks associated with them can directly affect NDE's financial results.

We think that these construction loans present two different risks to NDE if the housing market weakens and/or housing prices decline. A soft housing market could expose the credit risk of these loans, with the potential for defaults and foreclosures. NDE would likely have to increase its loan loss reserves and charge these increases against earnings. We note that the company's loan loss reserves have remained virtually unchanged over the past 5 years, while the amount of construction loans have roughly doubled. It is also important to note that NDE's book value stands at just $1.5B. Any substantial losses from these $2.5B in construction loans could significantly impair shareholder's equity.

Additional problems could result from the geographic concentration of these loans. 47% of the consumer construction loans and 57% of builder construction loans are located in California. While the California real estate market has been booming for several years, some experts think that a downturn is possible. In fact, according to a recent report by the FDIC, "many analysts argue that home prices in the hottest coastal markets, especially in the Northeast and California, could be poised to decline in the near future. For example, PMI Mortgage Insurance Company analysts place essentially even odds that home prices will decline during the next two years in a dozen cities in California and the Northeast."

The other risk associated with these construction loans is the possible loss of interest income if a housing slowdown occurs. These loans provided 14% of NDE's total interest income in 2005. More specifically, the builder construction loans yielded 10.01% in 4Q05 and without this segment, we estimate that NDE's NIM would have been 1.85% rather than the 1.98% reported. If housing starts and the volume of construction declines in 2006, NDE could lose an important source of interest income.

6. NDE's use of non-cash gain on sale accounting boosts near-term earnings but not cash flow and, in our opinion, this represents poor quality of earnings. Additionally, the amount of gain on sale per securitization and the value of the company's capitalized MSRs rely on management's assumptions for prepayment rates and discount rates. Changes or inaccuracies in these assumptions can have a significant effect on the company's financial results.

NDE recorded $592.2M in gain on sale revenue in 2005. However, this accounting is non-cash and is reflected as such on the cash flow statement as a $592.2M reduction to CFO. The company's 2005 cash from operations (excluding changes in working capital as well as activity from trading securities and purchasing loans held for sale) totaled just $34.4M or $0.52 per share. We note that capital expenditures on PP&E equaled $109.1M, resulting in FCF of negative -$74.7M, given the exclusions mentioned. In our opinion, this signals weak earnings quality.

As gain on sale revenues are recognized, MSRs are capitalized and subsequently amortized. Both the value of the gain on sale and the value of the MSR asset rely on management's assumptions for prepayment rates and discount rates. NDE does implement hedging instruments in attempt to protect its MSR value. According to one FDIC report from 1998, "gain on sale accounting can result in unstable capital ratios and volatile earnings. Gains generated from asset sales rely on management assumptions about the lifetime performance of the assets sold and may not materialize in cash if the assumptions prove incorrect."

7. Financial assumptions.

We forecast NDE will grow its mortgage production by 21% to approximately $73.8B, equal to management's guidance. However, in order to reach this goal, we expect that NDE will need to significantly increase (+82%) the amount of conduit mortgages it purchases from other originators. In our scenario, the lower gain on sale margins of conduit mortgages would bring the company's total gain on sale margin to 0.74% and its MBR margin to 0.98%. Management is guiding to a 1.20% MBR margin. Our NIM assumption and average earning assets are equal to management's guidance of 2.05% and $24.5B, respectively.

Driven by our lower than expected gain on sale and MBR margins, we expect total net revenues to equal $1.123B in 2006. This is 6.5% below the "street's" $1.201B expectation. We forecast G&A operating expenses to grow by 10%, to $658.2M. Assuming a 39.5% tax rate and 67.8M average diluted shares outstanding, we estimate 2006 EPS of $4.12. This compares to management's $4.88 guidance and the $4.78 "street" consensus.

Our 2007 EPS estimate of $3.57 is well below the $5.37 "street" consensus. This is based on continuing trends from our 2006 expectations. We expect that lower gain on sale margins and revenue will lead to disappointing top line and bottom line growth. We note that the MBA is currently forecasting a –3.6% decline in mortgage originations for 2007. We recognize that a great deal can change between now and 2007, particularly related to interest rates and their effect on mortgage revenue and net interest income. For this reason, we are focusing more on the company's 2006 results at this time.

Table 10
NDE Guidance compared to OWS estimates
($Ms)

	2005 Actual	2006 NDE Guidance	2006 OWS Estimates
Mortgage Production	60,774	73,825	73,707
Mortgage Market Share*	2.18%	3.12%	3.12%
Average Earning Assets	19,645	24,500	24,500
Net interest margin	2.14%	2.05%	2.05%
Mortgage banking revenue margin	1.37%	**1.20%**	**0.98%**
% of mortgage production sold	86%	88%	88%
Mortgage servicing/securities income	62	101	101
EPS including stock option expense	$4.42	**$4.88**	**$4.12**

* 2006 market shares are based on the MBA's latest mortgage originations forecast of $2.365T

Source: Company information, OWS estimates, MBA forecasts

8. We think that NDE should be valued as a mortgage company and not as a thrift, despite the company's and some "street" analysts preference for a thrift valuation. Excluding cash, we estimate that 97% of the company's interest-earning assets are mortgage or home construction related. As such, we use mortgage company comparable valuations for NDE.

We initiate with a price target of $33. If our thesis is proven correct, we expect that the bullish "street" sentiment and enthusiasm for NDE's future growth will be replaced by the reality of a more difficult mortgage environment, lower MBR margins and disappointing top line and EPS results. The $33 price target is based on an 8x PE multiple of 2006 EPS of $4.12. This multiple is based on the average multiple of 6 comparable mortgage originators/banks. However, we note that additional downside may exist. As recently as 2003, the stock traded at 6.7x forward earnings when sentiment regarding mortgage originations was negative. This would equate to $28 per share based on our 2006 estimates. Also, it is not unusual for mortgage banking stocks to trade as low as book value, as NDE did in both 1998 and 1999. NDE's current book value is $23 per share.

9. Financial model

Income Statement (000s)	FY2005	FY2006e	FY2007e
Net Interest Income	419,894	502,807	570,051
Loan Loss Provision	9,978	11,000	13,800
Gain on Sale	592,175	482,519	433,754
Other Income	103,619	148,500	136,000
Net Revenue	1,105,710	1,122,826	1,126,005
Total Operating Expense	-606,981	-658,200	-710,856
Net Income Before Taxes	498,729	464,626	415,149
Provision for Income Taxes	196,998	183,527	163,984
Minority Interest	-1,505	-2,000	-2,000
Net Income	301,731	281,098	251,165
Basic Weighted Average Shares	62,760	64,800	66,800
Basic EPS	4.78	4.31	3.73
Diluted Weighted Average Shares	66,060	67,800	69,800
Diluted EPS	4.54	4.12	3.57

% Change	FY2005	FY2006e	FY2007e
Net Interest Income	3.7%	19.7%	13.4%
Loan Loss Provision	22.1%	10.2%	25.5%
Gain on Sale	37.3%	-18.5%	-10.1%
Other Income	-1227.9%	43.3%	-8.4%
Net Revenue	35.0%	1.5%	0.3%
Total Operating Expense	29.4%	8.4%	8.0%
Net Income Before Taxes	42.6%	-6.8%	-10.6%
Provision for Income Taxes	42.6%	-6.8%	-10.6%
Minority Interest	463.7%	32.9%	0.0%
Net Income	42.6%	-6.8%	-10.6%
Basic Weighted Average Shares	5.5%	3.3%	3.1%
Basic EPS	34.6%	-9.9%	-13.4%
Diluted Weighted Average Shares	6.3%	2.6%	2.9%
Diluted EPS	33.5%	-9.3%	-13.3%

% of Revenue	FY2005	FY2006e	FY2007e
Net Interest Income	100.0%	100.0%	100.0%
Loan Loss Provision	2.4%	2.2%	2.4%
Gain on Sale	141.0%	96.0%	76.1%
Other Income	24.7%	29.5%	23.9%
Net Revenue	263.3%	223.3%	197.5%
Total Operating Expense	-144.6%	-130.9%	-124.7%
Net Income Before Taxes	118.8%	92.4%	72.8%
Provision for Income Taxes	46.9%	36.5%	28.8%
Minority Interest	-0.4%	-0.4%	-0.4%
Net Income	71.9%	55.9%	44.1%

Income Statement (000s)	1Q06e	2Q06a	3Q06e	4Q06e	1Q07e	2Q07e	3Q07e	4Q07e
Net Interest Income	116,669	122,410	127,092	136,635	139,476	141,736	141,071	147,767
Loan Loss Provision	2,500	2,500	3,000	3,000	3,300	3,300	3,600	3,600
Gain on Sale	119,461	125,678	121,755	115,625	105,461	111,593	110,771	105,929
Other Income	39,000	37,500	36,000	36,000	34,000	34,000	34,000	34,000
Net Revenue	272,630	283,088	281,847	285,260	275,637	284,029	282,242	284,097
Total Operating Expense	-157,477	-164,297	-164,673	-171,753	-170,075	-177,441	-177,847	-185,493
Net Income Before Taxes	115,153	118,791	117,174	113,507	105,562	106,588	104,396	98,603
Provision for Income Taxes	45,486	46,923	46,284	44,835	41,697	42,102	41,236	38,948
Minority Interest	-500	-500	-500	-500	-500	-500	-500	-500
Net Income	69,668	71,869	70,890	68,672	63,865	64,486	63,159	59,655
Basic Weighted Average Shares	64,000	64,300	65,300	65,600	66,000	66,300	67,300	67,600
Basic EPS	1.08	1.11	1.08	1.04	0.96	0.97	0.93	0.88
Diluted Weighted Average Shares	67,000	67,300	68,300	68,600	69,000	69,300	70,300	70,600
Diluted EPS	1.03	1.06	1.03	0.99	0.92	0.92	0.89	0.84

% Change	1Q06e	2Q06a	3Q06e	4Q06e	1Q07e	2Q07e	3Q07e	4Q07e
Net Interest Income	11.7%	27.0%	14.1%	26.9%	19.5%	15.8%	11.0%	8.1%
Loan Loss Provision	0.4%	3.9%	-15.0%	93.2%	32.0%	32.0%	20.0%	20.0%
Gain on Sale	-17.2%	-21.1%	-19.4%	-15.8%	-11.7%	-11.2%	-9.0%	-8.4%
Other Income	449.5%	6.2%	51.8%	-4.0%	-12.8%	-9.3%	-5.6%	-5.6%
Net Revenue	7.6%	-1.9%	-0.3%	1.5%	1.1%	0.3%	0.1%	-0.4%
Total Operating Expense	8.9%	9.0%	9.0%	7.0%	8.0%	8.0%	8.0%	8.0%
Net Income Before Taxes	6.0%	-13.9%	-11.0%	-5.8%	-8.3%	-10.3%	-10.9%	-13.1%
Provision for Income Taxes	6.0%	-13.9%	-10.9%	-5.9%	-8.3%	-10.3%	-10.9%	-13.1%
Minority Interest	81.8%	58.2%	19.9%	0.6%	0.0%	0.0%	0.0%	0.0%
Net Income	6.0%	-13.9%	-11.0%	-5.7%	-8.3%	-10.3%	-10.9%	-13.1%
Basic Weighted Average Shares	3.6%	3.2%	3.2%	3.1%	3.1%	3.1%	3.1%	3.0%
Basic EPS	2.0%	-16.5%	-13.8%	-8.8%	-11.2%	-13.0%	-13.6%	-15.8%
Diluted Weighted Average Shares	3.5%	2.3%	1.9%	3.0%	3.0%	3.0%	2.9%	2.9%
Diluted EPS	2.2%	-15.8%	-12.7%	-8.8%	-11.0%	-12.9%	-13.5%	-15.7%

% of Revenue	1Q06e	2Q06e	3Q06e	4Q06e	1Q07e	2Q07e	3Q07e	4Q07e
Net Interest Income	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Loan Loss Provision	2.1%	2.0%	2.4%	2.2%	2.4%	2.3%	2.6%	2.4%
Gain on Sale	102.4%	102.7%	95.8%	84.6%	75.6%	78.7%	78.5%	71.7%
Other Income	33.4%	30.6%	28.3%	26.3%	24.4%	24.0%	24.1%	23.0%
Net Revenue	233.7%	231.3%	221.8%	208.8%	197.6%	200.4%	200.1%	192.3%
Total Operating Expense	-135.0%	-134.2%	-129.6%	-125.7%	-121.9%	-125.2%	-126.1%	-125.5%
Net Income Before Taxes	98.7%	97.0%	92.2%	83.1%	75.7%	75.2%	74.0%	66.7%
Provision for Income Taxes	39.0%	38.3%	36.4%	32.8%	29.9%	29.7%	29.2%	26.4%
Minority Interest	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.4%	-0.3%
Net Income	59.7%	58.7%	55.8%	50.3%	45.8%	45.5%	44.8%	40.4%