



August 2004

## THE TEXAS HEDGE REPORT

Steven McIntyre and Todd J. Stein, CFA

[www.texashedge.com](http://www.texashedge.com)

### LIVING IN SIN – NEW CENTURY FINANCIAL (NCEN)

New Century Financial is an Irvine, California-based non-prime mortgage finance company. A sharp money manager friend suggested this new era product of financial alchemy might be an interesting way to capitalize on an impending real estate bust, particularly because New Century focuses on low quality credits many of which are in California (over 40% of loans). The company's market cap is \$1.6 billion and its book value registers just \$743 million. NCEN's dividend yield is currently 1.7%, but with its announced intention to convert to a REIT in Q4, the dividend should be hiked much higher fairly soon.

Highlights of New Century's business description in its 10K along with our comments are below:

- ❑ *Offer mortgage products designed for borrowers who generally do not satisfy the credit, documentation or other underwriting standards prescribed by conventional mortgage lenders*

**TH:** Basically, New Century writes the loans Fannie, Freddie and the others don't want

- ❑ *We have been originating and purchasing these types of loans since 1996 and believe we have developed a comprehensive and sophisticated process of credit evaluation and risk-based pricing that allows us to effectively manage the potentially higher risks associated with this segment of the mortgage industry.*

**TH:** Since they have only been around since 1996, they have only seen a more favorable declining rate environment for any period of time...they also claim to have a better model that allows them to play in sub prime – we have heard that before.

- ❑ *Our borrowers generally have considerable equity in the properties securing their loans, but have impaired or limited credit profiles or higher debt-to-income ratios than traditional mortgage lenders allow. Our borrowers also include individuals who, due to self-employment or other circumstances, have difficulty verifying their income through conventional methods, and who prefer the prompt and personalized service we provide.*

**TH:** Our customers have poor credit, unusually high amounts of leverage, and often can't document their income, but NCEN plans on overcoming these challenges by charging them more.

- ❑ *We originate and purchase loans through our wholesale network of 21,600 independent mortgage brokers and through our retail network of 72 branch offices located in 26 states, as well as our central retail telemarketing unit. We process and close loans through our 20 regional processing centers located in 14*



states. Although a significant percentage of our loans are originated in California, we are authorized to do business in all 50 states and regularly originate and purchase loans throughout the country.

**TH:** We focus on the most frothy real estate market in the country – California. The eventual bust could be more difficult and prolonged in California than other parts of the county.

- In 2003, we originated 91.8% of our loans through our wholesale channel and 8.2% through our retail channel. Of the loans that we originated, 75.1% were refinances of existing mortgages and 24.9% were for the purchase of residential property. Of the refinance transactions, 85.6% were cash-out refinances in which the borrower receives additional proceeds to pay off other debt or meet other financial needs.

**TH:** 64% of our loans are some sort of high risk, highly levered cash out refis, which historically have much higher default rates.

- Mortgage brokers can submit loan applications in two ways: (i) through an account executive in one of our sales offices or (ii) through FastQual<sup>®</sup>, our Web-based loan underwriting engine, at [www.newcentury.com](http://www.newcentury.com)... FastQual<sup>®</sup> generally provides the broker with a response in less than 12 seconds. Loan information from the brokers' own loan operating systems can be automatically uploaded to FastQual<sup>®</sup>. The system provides all loan products for which the borrower qualifies and thus enables brokers to offer their customers many options.

**TH:** Rapid loans qualifications. Could it lead to bad underwriting standards?

#### Wholesale Loans

	March 31, 2003	June 30, 2003	September 30, 2003	December 31, 2003
Principal balance (in millions)	\$ 4,236.6	5,319.0	7,991.1	7,581.9
Average loan amount (in thousands)	163	166	182	172
Combined weighted average initial loan-to-value ratio	80.9 %	82.3 %	81.8 %	83.9 %
Percent of first mortgage loans	98.8 %	98.4 %	98.8 %	98.3 %
Property securing loans:				
Owner occupied	94.4 %	94.6 %	95.1 %	94.5 %
Nonowner occupied	5.6 %	5.4 %	4.9 %	5.5 %
Weighted average interest rate:				
Fixed-rate	7.83 %	7.86 %	6.78 %	7.46 %
ARMs—initial rate	7.58 %	7.42 %	7.15 %	7.18 %
ARMs—margin over index	6.05 %	5.52 %	5.65 %	5.70 %

**TH:** Principal balance of loans is up 79% in 2003 – moderate growth but surely no bad loans though. Average loan amount is up, loan-to-values are up, percent of first loans is down, and the amount of ARM's is up – all bad signs.



Retail Loans				
	March 31, 2003	June 30, 2003	September 30, 2003	December 31, 2003
Principal balance (in millions)	\$ 452.8	484.0	648.7	7,518.9
Average loan amount (in thousands)	123	118	124	172
Combined weighted average initial loan-to-value ratio	78.0 %	78.8 %	80.4 %	83.9 %
Percent of first mortgage loans	99.3 %	99.0 %	97.0 %	98.3 %
Property securing loans:				
Owner occupied	96.5 %	96.6 %	95.6 %	94.5 %
Nonowner occupied	3.5 %	3.4 %	4.4 %	5.5 %
Weighted average interest rate:				
Fixed-rate	8.33 %	8.15 %	7.66 %	7.46 %
ARMs—initial rate	8.11 %	7.92 %	7.81 %	7.18 %
ARMs—margin over index	6.61 %	6.45 %	6.22 %	5.70 %

**TH:** More of the same. Loan quality by virtually all metrics shown is deteriorating.

Pool Type	Balance	WAC	FICO	Delinquency			
				<90 days	90+	REO	Total
Mortgage loans held for investment	\$ 4,727,504	7.16 %	624	0.66 %	0.58 %	0.02 %	1.26 %
Mortgage loans held for sale	3,383,266	7.22 %	617	0.08 %	0.26 %	0.01 %	0.35 %
Interim servicing	3,103,480	7.25 %	622	0.07 %	0.02 %	0.00 %	0.09 %
Servicing rights owned	351,884	8.08 %	591	2.61 %	4.11 %	0.18 %	6.90 %
<b>Total</b>	<b>\$ 11,566,134</b>	<b>7.23 %</b>	<b>621</b>	<b>0.39 %</b>	<b>0.44 %</b>	<b>0.02 %</b>	<b>0.85 %</b>

**TH:** Average FICO (credit rating) score of 621 – not the most comforting.

In sum, the company has only been around since 1996 and has never seen a rising/spiraling default environment. Given that they focus on the sweet spot of bad credits, largely in California, seeking cash out refis - we wonder openly if their earnings might evaporate almost overnight when the real estate market runs out of steam.

The company recently raised 2004 EPS guidance from \$8.25 to \$8.75. This means that the company trades at just over 5x earnings. Sounds very cheap until you consider the lack of confidence one can garner in the company's business model and earnings consistency. Low P/Es and the potential of a large double digit rate dividend payout are like siren calls to unsuspecting investors. We don't feel that this is a business that merits your investment. The accounting is simply too opaque as a public investor. With total assets exploding from \$894 million in 1999 to a mind boggling \$14.7 billion in June 2004, the



delinquencies and asset quality of NCEN loans is virtually impossible to analyze as new unseasoned loans dilute the amount of problem loans visible.

We are neither long nor short New Century Financial, but if pressed we would definitely lean more towards the short side as this might be a nice play to capture a meltdown in California real estate. Professional investors with enough tolerance for punishment to short NCEN might look at the company's long term put options as safer bearish plays.

---

*This communication is being provided for informational purposes only and is not intended as a recommendation or an offer or solicitation for the purchase or sale of any security referenced herein. It is being provided to you on the condition that it will not form the primary basis for any investment decision. Texas Hedge, its officers, owners, writers and affiliates may have positions (long or short), effect transactions or make markets in securities or options on such securities referenced herein. The information contained herein is of the date referenced and Texas Hedge does not undertake an obligation to update such information. We make no representation and give no warranty, either express or implied, with regard to the accuracy, timeliness or completeness of this information. Texas Hedge has obtained all market prices, data and other information from sources believed to be reliable although its accuracy or completeness cannot be guaranteed. Such information is subject to change without notice. The securities and ideas mentioned herein may not be suitable for all investors. Readers should consult with expert legal, tax, business and financial counsel before taking any action.*

