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Slow-Motion Train Wreck Picks Up Speed

Interview With Sy Jacobs, Founder and Investment Manager, Jacobs Asset Management
By SANDRA WARD

PEOPLE WHO READ OUR FOURTH OF JULY 2005 interview with Sy Jacobs would hardly be surprised by the current meltdown in the subprime loan market. And it should come as no surprise that Jacobs, with a 23-year history of covering the financial markets, predicted the debacle. He has also shined as the principal of the \$222 million Jacobs Asset Management in Manhattan, which includes a \$45 million private-equity fund. Last year, his market-neutral financial fund gained 16.8% after fees, compared with 13.8% for the S&P 500. Since the fund's start nearly 12 years ago, it has returned 16.4%, on average, versus 11% for the S&P. He sees the debacle deepening, but spies opportunities, as well, in the adversity.

Barron's: *Nearly two years ago, you saw the day of reckoning coming for subprime mortgage lenders.*

Jacobs: When we spoke in 2005, I was worried about what was brewing in subprime, given the loosening in underwriting standards and the extension of credit to those with little equity and the inability to pay the loans back unless housing prices continued to rise. I'm surprised how long it has taken to unravel, but it has. Michael Farrell at Annaly Capital Management has been calling it the slow-motion train wreck, and the fact that it went on for another year or two since we spoke only makes it worse because the credit markets accepted more and more risk and got thinner and thinner margins while the party was still going on. The events of the past two weeks would tell you that the train wreck is accelerating and is turning into a contagion. Subprime will bring down mortgage lending, housing and, in turn, the economy and the market.

Some insist the problems in the subprime market are manageable.

The problems in subprime are not self-contained. It is a pinprick to a larger problem, and it needs to be looked at that way. The notion that subprime home-equity lending is somehow ring-fenced because it is only 12% of total mortgage loans outstanding and won't affect the rest of the mortgage and housing market is absurd. First of all, subprime lending was over 20% of 2006's volume. That tells you it was growing rapidly as a percentage of the mortgage business when it hit the wall.



Gary Spector

Sy Jacobs

It also tells you that the subprime borrower was increasingly the marginal buyer of housing and tilted the supply and demand of housing that resulted in such big increases in home prices until late last year.

How will the problems spread?

Mostly through housing. This year is going to be much worse than 2006 for mortgage and housing credit, and 2006 already laid the mortgage industry low. Nearly \$700 billion of mortgages reset this year and nearly half of that is subprime. Remember 2004, when our esteemed former Federal Reserve chairman, Alan Greenspan, was exhorting us to take out adjustable-rate mortgages, the federal-funds rate was only 1% and had nowhere to go but up? Prime refinancing volume peaked in 2004, and the most popular loan product at that time was a 3/1 adjustable-rate mortgage, three years fixed and adjustable every year after that. Those are resetting this year after 17 quarter-point increases in the fed-funds rate. The subprime home-equity market peaked in 2005, and the most popular product from that year was a two-year-fixed, 28-year-floating mortgage. It resets this year, and now credit spreads are widening, **Freddie Mac** [ticker: FRE] is going to stop buying as much subprime, as are the capital markets in general, and a lot of capacity is exiting through bankruptcy courts.

The remaining players left standing are raising credit standards and cutting loan products and raising coupons on the products they continue to make. Housing hasn't bottomed, and it is just getting going to the downside.

How bad is the credit crunch?

It is spilling into the secondary market in the sense that credit spreads in the secondary market have widened in the past few weeks. We're seeing a reversal in the appetite for risk that we've seen for the past several years. Credit will get more expensive across asset classes, and that's another way in which the subprime contagion will spread.

Are you hanging on to your subprime shorts, or have you moved on?

In subprime, the decline has been vicious already, and we are starting to look elsewhere for that kind of juicy downside. **NovaStar Financial** [NFI] is down from 39 to 6 since we last spoke, and we are still short. We are still short some others, and I think **New Century Financial** [NEW] is very likely going to zero. Another that has more downside is **Fremont General** [FMT], which we've been short for two to three years already. Fremont is a little more complicated, but if you read the cease-and-desist order that the regulators issued to them two weeks ago, and which started its stock crashing, it is hard to see how they don't eventually seize the bank. They as much as call Fremont's

management incompetent and order them to stop doing business in subprime. Their losses from the loans they've made -- and they made \$31 billion last year -- are going to be huge. Another part of their business is condo and construction lending, and the regulators criticized them for lax controls in this area and inadequate reserves, as well. By the time they take proper reserves on those loans and because of the losses they'll experience getting out of subprime, we see them as capital-deficient. Given the criticism of management by the regulators in this cease-and-desist order and the probable desire to make an example of someone, I don't see the regulators being lenient with them, and I don't see how they will avoid getting seized and wiping out equity holders.

Some of these names have been bouncing back on capital infusions. Does that throw a wrench into your thinking at all?

No. People are bottom-fishing.

Where else do you see opportunities from the fallout in subprime?

We are still short **Bankrate** [RATE]. We were painfully early on Bankrate, judging from the fact the stock went from 20 at the time we spoke two years ago to 39 now. But we actually think our original thesis is unfolding now and see Bankrate as a play on mortgage velocity, which is coming down. Organic growth has all but stopped, as you can see from the deceleration of their page-view growth, but they have made some acquisitions. They've surprised on the upside with earnings expectations because they raised prices aggressively for advertising on their site with Internet banner ads and click-throughs. We think the price increases on ad rates are unsustainable. Their customers are mortgage brokers and mortgage bankers. These mortgage bankers and brokers will go out of business in droves in 2007. You could see big revenue disappointments at Bankrate, which won't go over well with the stock trading at 30 times 2007 estimates.

Where else do you see trouble brewing?

A secondary way we've found to play the demise of subprime and its fallout is by shorting the credit-rating agencies: Moody's [MCO] and McGraw-Hill [MHP], which owns Standard & Poor's. Standard & Poor's is 44% of McGraw-Hill's revenue and 76% of their operating profits. By our calculations, Standard & Poor's is over 100% of McGraw-Hill's profit growth because the rest of their businesses haven't been growing. Moody's and Standard & Poor's have been major beneficiaries of the wild growth in the structured-finance business such as CDOs [collateralized debt obligations] and RMBS [residential mortgage-backed securities] and subprime. The bulls would say that only 7% of their business is subprime. But when you add CDOs and RMBS and subprime together, all of which we think is driven by the home-equity business, the number jumps to roughly 20% of the rating agencies' revenue.

Revenues per deal on these three segments -- CDO, RMBS and subprime -- are three to four times that of the rating agencies' lower-growth and lower-margin corporate-finance business, which is rating corporate bond offerings. The areas we are focused on are contributing more like 30% to 40% of operating profits at Moody's and Standard & Poor's, and most of the growth in earnings. Subprime issuance is going to shrink dramatically this year, and a big chunk of CDO volume is backed by subprime assets, and so the rating agencies' entire structured-finance operations should see a big drop in growth this year, especially in their high-margin areas, and that's underappreciated by the stock market.

In light of the fact that Moody's is trading at 25 times estimates of 14% earnings growth and McGraw-Hill is trading at 22 times estimates of 16% earnings growth, and we see both missing their estimates this year and possibly showing little if any earnings growth, those multiples could get hurt badly. Besides the earnings risk, there is great regulatory and legislative risk here. When Barney Frank and Nancy Pelosi hold their hearings later this year or next year on what went wrong in subprime and why it caused so many foreclosures among their constituents, the rating agencies profiting from the growth of all this misguided credit extension will not escape their wrath.

Jim Grant of the Interest Rate Observer makes a really great point that is germane to what I'm talking about, which is that people will want to know how Wall Street was able to take a pile of subprime home-equity loans that were poorly underwritten and slice and dice them and turn them into CDO or asset-backed securities where about 80% of them were rated double-A or triple-A, and yet many of those loans are going to go bad.

Are you positive on anything?

We will see aggressive fed-funds cuts this year and next in response to what is perceived as the second leg down of the housing market and its chilling effect on the consumer. The trick is to find financials that are sensitive to short-term interest rates but not to credit, and there aren't many. Our favorites would be residential- mortgage REITs. When we spoke two years ago, we were short Annaly Capital Management [NLY], and we rode it down from the high teens to the low teens as short rates were rising and the yield curve inverted and it hit Annaly's book value and dividend-paying ability. We've since covered it and gone long. They own prime-agency mortgage securities with no credit risk, and they lever them with short-term borrowing, a pretty simple model. With the end of Fed tightening, the dividends will head back up and will accelerate to the upside if the Fed cuts rates. Annaly is the biggest of the residential mortgage REITs, with a \$4 billion market cap. It trades at a premium to book value because it is so liquid and accessible.

Our favorite way to play the residential mortgage REITs is Anworth Mortgage [ANH], which is our biggest long position. It is a \$400 million market cap and it trades at only 87% of book. We love the guy who runs it, Lloyd McAdams, because he thinks like a shareholder and bought back a lot of stock when the shares were even lower than they are today, despite the fact that shrinking their balance sheet runs counter to his personal

compensation in the short term. They own a greater percentage of adjustable-rate mortgages than Annaly does, and those will benefit more as they are reset upward, and because of that they are facing a sweet spot in late 2007 and 2008 when their funding costs go down on the Fed cuts we expect and their ARM assets are still repricing upward. Book value, which is now \$9.75 a share, should rise to about \$11 over the next few years as the value of their adjustable-rate mortgages go up. We think they could revisit their 2002 peak earnings of \$2 a share by 2008 or 2009, and the stock, now 9 or so will trade back up to around its old high of 16.65.

Any others along these lines?

A racier way to play mortgage REITs would be to buy Opteum [OPX]. Two-thirds of the company is a credit-risk-averse mortgage REIT just like Annaly or Anworth, and one-third of it is an ATL-A, or low-documentation mortgage originator -- a result of a horrible, ill-advised acquisition in 2005, and the market has really hammered the stock for it. But it has gone too far. Book value is \$7.85 a share and the stock is around \$4.50, so you can buy it for less than 52% of book.

If the Fed cuts rates, their REIT is a major beneficiary. We think they should just liquidate or sell the origination operations for a small hit to book value. But, lo and behold, Citibank bought 7½% of the originator for 150% of book at year-end 2006. They are losing money now, but we would expect them to return to profitability in the second half of '07, even without the Fed cutting as their ARMS reset in price and book value goes up. If the Fed cuts, they will be quite profitable and have big dividends again, and the stock should trade up to or above book value.

Let's go back to your view that there is going to be some aggressive easing. How does that square with some of the inflation data that we are getting?

It will prevent the Fed from easing in the short term. But again, if we are right that a credit crunch in mortgages is developing and are right about its effect on the consumer, by the middle of this year, inflation will be the least of the Fed's worries.

Any other bright spots?

We are long Origen Financial [ORGN], a REIT and the only remaining player in manufactured-housing finance. With the end of the housing boom and a possible decline in home ownership, especially in the low end of the market, manufactured housing would benefit.

Thanks, Sy.

Table: Jacobs' Picks 'n' Pans

Picks and Pans

Pans

Company	Ticker	Recent Price
Fremont General	FMT	\$9.28
Bankrate	RATE	39.07
Moody's	MCO	66.40
McGraw-Hill	MHP	65.36

Picks

Company	Ticker	Recent Price
Annaly Capital Mgmt	NLY	\$14.94
Anworth Mortgage Asset	ANH	8.94
Origen Financial	ORGN	6.30
Opteum	OPX	4.14