July through December 2003 Three Dollars

EQUITIES

ACCREDITED HOME LENDERS:

Co-founders Jim Konrath and Ray McKewon

Ride the Year's Hottest IPO

Plus: Nine new stocks from Our Favorites of the Famous who beat the S&P 500 13 of the last 16 times!

An IPO Valentine

A stick with the basics approach to the mortgage business helped Accredited Home Lenders succeed in the risky non prime housing market where so many rivals have failed. Underwriter Friedman, Billings and Ramsey has the hottest IPO of 2003 and still a low-p/e stock.

By David R. Evanson

In l990 Chairman and CEO Jim Konrath, experienced in mortgage lending and consumer finance, and Executive Vice President and Secretary Ray McKewon, a veteran stockbroker and venture capitalist, co-founded Accredited Home Lenders (NASDAQ: LEND -31.13).

Using proceeds of $30,000 of their own personal savings, proceeds from margin advances and their own credit cards, they made the transition from mortgage broker to mortgage banker. Real entrepreneurs, they started off with just three employees in 800 square feet above a San Diego auto parts shop.

Culture of Profitability: *"The key to success is originating loans with borrowers who pay you back," stresses Accredited Home Lender Holding Executive Vice President and co-founder Ray McKewon (right) with Chairman Jim Konrath (left) and President Joseph Lydon (center). "It's not just loans, but profitable loans that separate the winners from the losers in the non prime mortgage business."*

Humble beginnings indeed for the hottest IPO of 2003. LEND was one of the few emerging companies in good enough shape to go public back then when lead underwriter Friedman, Billings Ramsey & Co on February 14, 2003 priced the IPO deal at $8.00 per share, versus the $11 management had initially hoped for.

At a recent high of over $33, LEND shares had a gain of over 300%. Talk about a hug for Valentine's Day. Best of all, LEND with 2003 estimated earnings per share at $4.85 to $4.95 and 2004 estimated earnings of $5 to $5.25, is still bargain–priced with projected p/es of well under 7.

This national residential mortgage lender focuses on the sub prime market. "We make loans to folks with past credit problems, limited credit histories or inadequate income documentation," says Ray McKewon,who was speaking at EQUITIES 52 Anniversary Conference. "That's why in the very beginning, we could not get a warehouse line to fund our loans. Lenders thought our loans were too risky. But we knew if managed correctly, and priced for risk, non prime was a great market." Presently, Accredited is originating loans at a rate of $7 billion per year. The company holds some of these loans on its' books, earning a spread between the cost of funds and the loan coupon, but sells the bulk of them to other investors.

In l994 and l995 LEND raised $5 million in venture capital and so was destined to become a public company. But wisely, management didn't rush.

In a classic tortoise versus hare move in 1997–one that makes all the difference in the world today–Konrath and McKewon decided to sell the loans rather than securitize and therefore recorded cash gain on sale versus the more liberal non-cash gain on sale treatment.

Many rivals using the more aggressive so called non - cash gain - on - sale treatment for securitizations booked the present value of expected future spreads as income in the current period. This typically results in a massive asset on the user's books known as an I/O (i.e. interest only) Strip. While gain on sale accounting is well documented under GAAP accounting, and results in more income faster, it none the less relies on a number of assumptions about prepayments and defaults, which can and do prove incorrect. It can also lead to bankruptcies.

In 1998, just a year after Accredited decided to 'take the road less traveled', mortgage rates fell, prepayments flooded in and delinquencies soared proving just how wrong the assumptions of lenders could be. The I/O strips of most of the large mortgage companies suffered massive write downs causing default on the warehouse lines they were backing. Almost overnight the mortgage business was thrown into a liquidity crisis, followed by a massive sell off in the equity markets. Once high flying companies like First Plus, The Money Store and Conti Mortgage went out of business, lightening the portfolios of investors by billions.

Accredited was private at the time, but nonetheless to its credit walked away from the mortgage banking crisis unscathed. "We didn't have any assumptions to apologize for," says McKewon. "We simply booked income as we received it." And freed from the anxiety of the rest of the mortgage industry management has been able to focus on just two things: growth and profits.

Growth has come in the form of channel expansion and geographic expansion. Today Accredited does business in 50 states, originating loans wholesale through brokers, and at the retail level through its Axiom Financial and Home Funds Direct business units. Since 1998, originations have grown from $542 million annually, to last years' $4.3 billion, a compound annual growth rate of 68%. Capitalizing on the boom in refinancing to pay down high interest credit card and consumer debt, Accredited is on track to originate $7 billion in loans in 2003.

Originations are one thing, but profits are another. Ray McKewon says that Accredited approaches the latter through credit quality, prepayment fees and loan profitability-based incentives on originations. Working together, all these strategies are paying off. Accredited delivered $28.8 million in earnings, or $1.98 per diluted share, on revenues of $200.8 million in 2002, up from earnings of $17.4 million, or $1.32 on revenues of $119 million the prior year. Earnings per share in 2003 could exceed $4.85.

The value of prepayment fees, which McKewon says are on about 85% of the portfolio, cannot be underestimated. In a declining interest rate environment, which we have had for almost two years, loans originated for a 15 or 30 year term get paid off in one–not even enough time to capture the origination costs–as borrowers refinance to lower their monthly payments.

"Our prepayment fees can dampen prepayment activity before it even happens," says McKewon. But in the event that it does, fees equivalent to 5% of the face value of the loan, or 6 months of interest on the outstanding balance, help Accredited break even, or turn a small profit on long-term - loans that suddenly go short term.

Although mortgage brokers originate about 90% of loans, Accredited re-underwrites them to make sure they conform to the company's guidelines. This, combined with a focus on the upper end of the sub prime market – 70% of loans originated had credit scores of 600 or higher – has enabled Accredited to build a portfolio that has consistently outperformed sub prime indexes of loan delinquencies.

For instance, slightly less than 2.4% of loans originated by Accredited in 2001 are more than 60 days delinquent, while the industry average computed by LoanPerformance's Subprime index is more than 10%. "Too many people believe that the mortgage business is one of originations," says McKewon. "The key to success is originating loans with borrowers who pay you back."

To make sure this happens, McKewon says that "Loan origination personnel are paid for producing profitable loans, not just loans." The centerpiece of this effort is Accredited's revenue calculator platform which gives front line personnel 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 increase or decrease the compensation they will get for making the loan.

McKewon says the revenue calculator is but one element of a culture that is key to the company's success. "Accredited has a culture of profitability," says McKewon. "This is an invaluable asset you cannot buy at any price."

Of course, as today's unusually low interest rates start back up, home refinancing will tail off. But as long as LEND keeps making money on its deals, the company should be a cash cow for many years.

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SHARE DATA

Recent Price:	$31.13
52 Week Price Range:	$33.10-6.99
Fully Diluted Shares Outstanding:	20.4 million
Float:	9.7 million
2002 Diluted EPS:	$1.98
2003E Diluted EPS:	$4.85-4.95
2004E Diluted EPS:	$5.00-5.25

BALANCE SHEET DATA
(As of June 30, 2003)

Total Assets:	$2.5 billion
Long-Term Debt:	$979.9 million
Shareholders' Equity:	$58.0 million
Book Value:	$2.84

RISKS Sub prime is the riskiest end of the mortgage market and is sensitive to changes in interest rates and the economy. A prolong period of economic deterioration could result in increases in defaults and delinquencies in Accredited's portfolio. Further, more than a third of the company's loans are originated in California, which has economic issues of its own which extend beyond the economy at large. A spike in interest rates could reduce the spread Accredited earns on loans, or cause losses in the company's hedging strategy. The company funds it loans with warehouse lines of credit. If access to these lines of credit are restricted or revoked, Accredited may be unable to fund loans or may experience a decrease in origination volume. ❑

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