



## What we are hearing... and what it means

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“How it works out is really a dart toss, anyone’s guess” (1)

“The US will bear the brunt of an inevitable slowdown of consumer spending. The effect on the real economy in the rest of the world depends on whether there’s a hard landing in the US” (2)

“It is a bleak picture for mortgage lenders, in terms of defaults for the next year and in terms of losses for the next two years” (5)

“No securitizations will be issued in sub-prime mortgage in the next 12 to 18 months - no one trusts the rating agencies” (2)

“it’s a business that has validity but at a much smaller size. Maybe it should be one-quarter the size it used to be. But that is still big” (4)

Sources: (1) Richard A. Yamarone (Director of Economic Research, Argus Research)  
(2) Mortgage trader major Wall Street bank  
(3) Nouriel Roubini (Economics Professor, NYU)  
(4) Wilbur Ross (Business Week, August 9, 2007)  
(5) Michael Youngblood, managing director of ABS research FBR Investment Management

“You need to worry about who is left in the origination arm and whether you want them” (1)

“The data often isn’ t there to properly analyze the portfolio” (3)

“The crisis in the United States subprime lending market will run for three years and more than US\$300 billion of subprime mortgages could fail” (5)

“Timing will be everything - you don’ t want to jump in too early - resets are a pig in the snake - but you don’ t want to miss the opportunity” (2)

“There is likely to be a further two million mortgage defaults before the current cycle is complete” (4)

Sources: (1) Scott Carnahan (Former Partner, KPMG)  
(2) Principal - FS focused PE Fund (September 2007)  
(3) Principal - FS focused PE Fund (September 2007)  
(4) Bill Gross (Chief Investment Officer, Pimco hedge fund)  
(5) Jack Melvey (Chief Global Fixed Interest Strategist, Lehman Brothers)

## Opportunities & Strategies

- There has been a precipitous drop in supply of subprime mortgage loans without an equal decline in demand. This should lead to lower risk and more profit for those positioned to take advantage of the market.
- Capital is key – the old business model of originate and sell cannot be relied on anymore. Survivors will need to be able to originate and hold during periods, sometimes extended periods, of being unable to sell to the market. Access to a deposit base may be essential to obtain low cost, longer term funding required to hold loans in portfolio for longer terms.
- Be prepared to weather the storm; things are likely to get worse before they get better as \$400 billion of subprime loans will reset in 2008 with some months having more than \$40 billion. You should price into the deal increases in delinquencies and defaults, including the related increased operational costs.

## Diligence thoughts

- Diligence on opportunities will take longer and require both sector specific experience and deal expertise.
- You need to diligence the portfolios focusing on documentation levels and reset timing. Start the portfolio analysis early as the data required likely will not be close at hand and may need to be mined and/or created.
- Evaluate the current underwriting policies and procedures and note the evolution of such policies and procedures over time. Determine if any significant change would have an impact on whether historical results are predictive.
- Perform financial diligence to analyze historical profitability and bridge historical results to forecasts. Stress test forecasts. It is an entirely new paradigm. The only thing you truly know about the forecast is that it is not right. Surface and evaluate the key assumptions in the forecast model – are they realistic in the new environment?
- Use valuation and modeling specialists to determine both the current “fair” value of net assets including securities and retained interests and to assist in determining a more normal state value;
- Evaluate the quality and efficiency of loan servicing, especially delinquent account collection and foreclosure – can operations expand to meet additional delinquency?;
- Review target’s systems’ functionality, capacity, and stability – particularly the servicing platform. Is it capable of handling additional delinquency and foreclosure volume;
- You will need to spend more time than normal reviewing the people outside of the executive suite, especially the originators, to determine if the top quadrant of producers are still around.