

Downey Short Sellers Pitted Against Hopefuls By Dan Beighley - 5/7/2007 Orange County Business Journal Staff

Downey Financial Corp., a regional savings and loan operator based in Newport Beach, has gotten national attention as a possible acquisition target and for its place in a vulnerable market.

The ongoing subprime mortgage meltdown and cheerless first-quarter earnings from Downey have put the thrift in the crosshairs of short sellers betting its loan portfolio is in trouble.

"The deterioration of Downey is likely to be slow and could take nine to 12 months to set in," said Amit Chokshi, managing member of Kinnaras Capital Management LLC in Stamford, Conn., a hedge fund manager.

To Downey's defense, the mortgage meltdown, so far, has been limited to subprime loans made to borrowers with imperfect credit. Less than 6% of Downey's loans are subprime, according to the thrift.

And shares of Downey actually are up since it reported results last month, testing the resolve of its short sellers.

The company could have Jim Cramer of TV's "Mad Money" to thank for that.

Just after Downey came out with results, Cramer touted the stock as having the potential to double in a buyout.

He cited strong first-quarter results from Wachovia Corp., which was helped by October's buy of Oakland-based Golden West Financial Corp., a thrift with similarities to Downey.

According to Cramer, Downey could be "the next Golden West."

Buyout speculation is nothing new for Downey, a sizable regional thrift in an industry dominated by banking heavyweights. Cofounder and Chairman Maurice L. McAlister dominates with a 20% stake.

Earlier in the year, the company said it entered into change-of-control agreements with top executives, fueling further speculation.

For all the commotion, little has been said by Downey, which doesn't hold conference calls. Executives declined to talk for this story.

Q1 Earnings

Downey's first-quarter profit slipped nearly 2% from a year earlier to \$43 million, due mostly to higher operating expenses and fewer sales of loans to investors. Assets declined 14% to \$15 billion as the value of loans were written down.

"Last year's challenging business environment, characterized by a softening in the residential housing market and an inverted yield curve, has carried into 2007 and contributed to further declines in our loan portfolio," Downey's Chief Executive Daniel D. Rosenthal said in a statement.

Downey and others have been dealing with an inverted yield curve, where interest rates on short-term investments exceed those of mortgages and other long-term investments.

Shares of Downey are off about 8% from February. The company had a market value of about \$1.8 billion last week.

Some are betting Downey could fall further.

Some 35% of Downey's shares were shorted in April, up 20% from March and double from February.

Nay Sayers

The shorts have two main arguments for betting against Downey.

First, the company faces potential risk from option adjustable rate mortgages, which offer low rates for the first few years and then go up.

Option ARMs made up 80% of Downey's loans held as investments in the first quarter. Of that, about 10% are Alt-A loans-in between the riskiest subprime loans and the best mortgages.

Option ARMs give borrowers different payment options, including credit card-style minimum payments. Loan interest beyond a minimum payment gets tacked onto the loan, causing them to negatively amortize.

Second, Downey's profits could slip further as it accounts for payments it has yet to receive on negatively amortized loans. The number of loans delinquent for 60 to 90 days at Downey has almost tripled from a year ago.

And many borrowers soon will face the pressure of higher monthly payments.

The majority of Downey's option ARM loans were made in 2004 and 2005, which means many should reset this year.

Interest income from negatively amortized loans has driven Downey's results in recent years, according to some short sellers.

About 31% of Downey's first-quarter interest income of \$125 million came from negative amortization, up from 29% in the fourth quarter and 25% a year earlier.
Orange County Business Journal, Copyright C 2007, All Rights Reserved.