

## Third Quarter 2007

The summer has been far from languid, as the credit markets went haywire in mid-June and then went from bad to worse just as vacation season started at the beginning of August. This turmoil spilled over into virtually every debt market and also caused significant disruption in the stock market.

The catalyst for the declines was initially credit problems with sub-prime mortgages that began to come to light in the first quarter of 2007. Lending standards had gotten quite lax over the past few years, and lenders made loans to borrowers who fundamentally could not afford them. Those chickens have finally come home to roost. Some data from 2006 indicate that the default rates on sub-prime mortgages may reach as high as 20-30%, compared to historical averages in the 5-8% range. With nearly one out of every 3 loans defaulting, it is easy to see how there are problems.

At the end of the first quarter, the concerns were largely limited to the sub-prime mortgage segment of the market. The damage, while quite severe for those heavily exposed to this asset class, was fairly isolated. In the second quarter some other problems came to light. Countrywide took a \$388 million impairment charge due to credit problems in prime loans, with delinquency rates of about three times the historical average. These were not sketchy loans held by people with poor credit, but "A" loans held by people with good credit. Panic quickly engulfed the markets as fixed income investors questioned the quality of fixed income investments of any kind.

The reaction to this problem was far worse than the problem itself. Investors simultaneously backed out of many of the world's debt markets, and were unwilling to invest in mortgages, commercial paper (short-term corporate debt), and asset backed securities. This caused major disruption for lenders, with many going out of business and others securing emergency financing. Prime lenders American Home and Homebanc shut their doors completely. Thornburg sold a huge portfolio of AAA-rated loans at an unheard-of discount to raise liquidity, and Countrywide received \$2 billion of emergency liquidity from Bank of America.

The problems continued to spread as financial companies of all kinds found it nearly impossible to find financing. Rates for prime borrowing jumped, leading to markdowns of existing debt. This led to balance sheet impairments for companies that held debt of almost any kind. A 2-5% impairment is not much of a problem for a company with little leverage, but with leverage of 10-20x, the impairment is 20-100%. Some balance sheets were wiped out completely by a single one-time impairment.

Despite the seemingly catastrophic events, it is worth noting that the only actual defaults that have been reported are in sub-prime mortgages. By most accounts, virtually all other borrowers are paying their bills. As Countrywide's CEO Angelo Mozilo said on CNBC, there is more form than substance in this panic, but form will become substance if it goes on long enough.

We are not nearly out of the woods yet. Most of the impairments in Q2 included just two weeks of problems starting in mid-June. Q3 will almost certainly contain more impairments, as things got really bad at the beginning of August and have not yet recovered. September should prove interesting, as vacation season ends and everyone comes back to the office to figure out how to move forward. It is entirely possible that this will spark a recession, as consumers who have been spending borrowed money for years will finally begin to cut back and save.

Many observers note that this correction is long overdue. Lending standards had been lax for a long time, and many investors had become complacent about accepting risk. However, many investors are now as overcautious as they were reckless. Backing out of the market completely causes more problems by eliminating liquidity. Eventually, balance will return to the markets, though it could be a few more quarters.

## Updates

For those of us nearly fully invested in the equity markets, with an emphasis on the financial sector, our exposure to this turmoil is significant. When panic ensues, the stock market tends to over-react by selling off in all sectors, and then selected companies recover as investors assess the damage. I expect most of our companies to substantially recover, and many should even get a tailwind as the markets re-price.

Most companies in our portfolios have surplus liquidity, and many have either established share buyback programs, the ability to make new investments, or both. Companies that had "dry powder" and were having trouble finding new investments should find their situation improved.

Let me touch on some of our individual investments.

### ECC Capital

Our cigar butt penny stock has been adversely affected by the credit crunch. ECC is a sub-prime lender that sold off its business operations and now is just a shell that holds some mortgage assets. The meltdown in sub-prime mortgages was not really the problem, as ECC's remaining deals were written before 2006 and are actually not performing too poorly, and they fortuitously closed their origination business before the environment got really bad. The problem was the unprecedented and unexpected shutdown of the secondary market for mortgages of all kinds, and especially sub-prime.

At the beginning of 2007, ECC's plan was to monetize their remaining assets and pay out the cash to shareholders. This payout was expected to be substantially higher than our cost basis, so our returns in this stock were (and still are) expected to be in the form of distributions, not an increase in share price. However, as the credit markets entered deep freeze, ECC became unable to sell any of their assets. Now, they must continue to manage the assets and wind them down, which will both take longer and cost more money than expected.

I have talked at length with Roque Santi, ECC's CFO, to both learn more about the business and to let him know what we expect as shareholders. I still believe that we will receive substantial distributions in early 2008, though the stock may trade quite poorly in the meantime.

### USG

USG is directly affected by the housing market downturn, since they have substantial exposure to residential building. When the housing market went from bad to worse in Q2, USG reported a precipitous drop in earnings. However, USG is the #1 leader in both manufacturing and distribution of gypsum wallboard, has a very strong balance sheet, and has spent billions over the past few quarters expanding their business during this down cycle.

USG also has a favorable tax position, including a tax refund of over \$1 billion received in Q1 and substantial tax loss carryforwards that will offset taxes on income earned in the future. Finally, it is of course comforting to be invested alongside Warren Buffett who owns around 17% of the company through Berkshire Hathaway, and who was recently making open market purchases of the company above \$40.

USG is a classic cyclical stock, and while the ideal time to buy such a stock is at the lowest point in the cycle, that is very hard to do. I have no idea how bad or how long this downturn in the housing markets will be, but buying the stock when the valuation is very favorable and when the company will have numerous tail winds when the cycle turns is a likely formula for success. We probably won't see decent performance from this stock in the remainder of 2007, but I am optimistic about 2008.

### First Marblehead

A long-time, and seemingly perpetually troubled, holding of ours, Marblehead's business performance has been excellent lately, but not without clouds on the horizon. The business can be divided into two sides, the sourcing of loans and selling them to investors. On the sourcing side, the company has been growing at a phenomenal rate. Loan volume is growing at 60-80% per year, and their client base is broadening and growing rapidly. Loan mix is moving towards their higher-margin "direct to consumer" loans, and their television marketing campaigns are proving very successful.

Marblehead packages these loans into securities and sells them to investors, and that is where they are probably going to have some problems. Their last deal was done on June 14th, just before the credit market turmoil. Their next deal is scheduled for mid-September but the appetite that investors have for their securities is a big question mark. Marblehead's loans are not sub-prime, are not mortgages, have not had problems with defaults, and have been profitable for both lenders and investors. Nonetheless, a disrupted credit market simply might not want to participate in the near term. It is nearly inevitable that their September deal will have less favorable terms and may even be postponed or cancelled, which is particularly unfortunate since this is seasonally their best quarter (i.e. back to school). While I feel that Marblehead will eventually find investors, their results over the next quarter or two will be disrupted.

One cloud after another has passed over Marblehead's skies over the past few years. Dan Meyers, co-founder and CEO, abruptly resigned two years ago due to a scandal with a customer representative. But rather than dooming the company, its growth accelerated as the remaining management team matured. Two years ago, Marblehead was heavily reliant on their top two customers, and many observers expected one or both of them to leave. Instead, business from those two customers has grown substantially, and growth from other customers has grown even faster. Marblehead's margins were expected to contract as volumes grew. Instead, the opposite has happened, as their highest margin products represent a larger percentage of business than a few years ago. Sallie Mae recently struck a deal to be acquired by a private equity firm in conjunction with Marblehead's two largest customers. This was expected to disrupt Marblehead's business and increase competition. Instead, it is looking like the Sallie Mae deal won't go through as planned, and in any event, Sallie Mae is focused primarily on the federally guaranteed student loan market, not the private student loan market as is Marblehead.

The latest problem is growing political interest in examining or reforming the student loan industry. At issue are recent scandals involving kickback schemes and conflicts of interest among lenders and college officials. Most of the attention is on federally backed student loan programs, not Marblehead's private student loans, but Marblehead is under examination as well. Time will tell how

much this will impact Marblehead's business. However, Reuters reports that the "biggest impact is likely to come from proposed cuts in subsidies paid by the government to lenders of federally guaranteed student loans". This would strike a blow against Marblehead's competitors, not Marblehead, and would likely increase demand for Marblehead's services. As has been the case for the past 2 years, perceptions have far outweighed the facts surrounding Marblehead.

There is no joy in owning a company that is seemingly constantly under a dark cloud, but I continue to focus on Marblehead's fantastic business performance. The stock continues to be priced on a "worst case" basis, and they have already demonstrated better-than-worst case outcomes on many issues. It is a "Rodney Dangerfield" stock – it gets no respect. Meanwhile the company is still growing at a very high rate, is broadening its franchise, produces huge cash flows, and requires no external financing. One amazing statistic is that Marblehead has already returned more than twice its 2003 IPO cash proceeds to investors in the form of dividends and buybacks.

Marblehead fills a necessary niche in the student lending market, as the costs of education continue to skyrocket but the supply of federally-backed lending programs is nowhere near keeping up with demand, and this tail wind should continue to propel them forward.

### Brookfield Asset Management

Brookfield Asset Management, a long-time holding, is heavily involved in the international debt markets. Their exposure to US residential housing and mortgages of all kinds is minimal (approximately 5% of their balance sheet and a smaller portion of operating income), and they have virtually no exposure to sub-prime. Brookfield has heavy exposure to premier commercial real estate, which so far is not showing any impairments. As a direct owner and manager of properties, Brookfield is not very exposed to mark-to-market changes, and derives cash flows from numerous sources in numerous countries. Brookfield has a very favorable liquidity position, having just raised \$500M of debt at excellent terms and is soon to realize \$200M of proceeds from the sale of an interest in a steel company. They recently authorized the repurchase of 10% of their stock.

Over the past 5 years Brookfield has enjoyed the very favorable credit markets, and has used them to obtain ultra-cheap financing. This benefit is clearly going to be impaired in the short term and may not fully recover. Over time I believe that Brookfield will continue to find deals on good terms and continue to expand, in the meantime they will use their substantial liquidity to support their current assets and buy back significant amounts of stock. Bruce Flatt, Brookfield's CEO, and other executives are required to own stock in BAM equal to 5 times their annual salary, and many own many times more than that, so we can be sure that their attention is keenly focused.

### Business Development Companies

Business development companies (BDC's) are essentially publicly traded private equity funds. BDC's raise financing and use it to make investments in corporations, usually "middle market" or fairly small private businesses. Investing in BDC's at or below their net asset value provides an excellent way to harness the expertise of motivated private equity investors and get exposure to a broad selection of middle market companies.

BDC's must mark their portfolios to market each quarter. The current credit crunch has caused a "re-pricing" of debt instruments of all kinds, including those that make up the investment portfolios of BDC's. This has led to mark-to-market impairments for many BDC portfolios, though the impairments are largely due to market volatility, not any change in the credit quality of the underlying companies.

A temporary market impairment can become a big problem if the investor is highly leveraged or needs to exit the investment in a hurry. BDC's by law can only use modest leverage (maximum debt: equity ratio of 1:1, or asset coverage of no less than 200%), and tend to hold investments until maturity. Thus most BDC's are not susceptible to the kind of forced selling and permanent impairments seen in highly leveraged investors such as hedge funds and MREIT's. Far more important than this market value is the financial health of the borrower and their ability to repay, which BDC management is typically skilled at evaluating.

After discussing the current market conditions with management at several BDC's, I learned that they are seeing market declines of around 2-3% for the higher quality assets, and around 5-10% for the lower quality assets. Meanwhile, so far we have not heard of any actual payment or credit problems. Corporate credit quality has recently been quite good. The average historical delinquency rate for corporate debt is around 1.5% and that rate is currently near 10-year lows at 0.3%. Generally, BDC's carry far less leverage and have delinquency rates lower than the typical mortgage lender. This all adds up to relatively modest impairments.

Additionally, and perhaps most importantly, BDC's with uninvested capital will be in an excellent position to make new investments at new prices. In a market starved for liquidity, cash spells opportunity. BDC's that have been cautious in recent years and have waited patiently with their cash for an opportunity to act should now be very busy.

We are currently invested in three BDC's. Over the past few weeks I was able to get some excellent prices in these stocks, at 20-25% discounts to their net asset value.

At Gladstone Investment Corporation (GAIN), industry veteran David Gladstone has for over a year been lamenting his team's inability to find suitable investments because prices have been too high and quality has been too low. As a result GAIN has a substantial cash position and has not tapped its line of credit. That liquidity in combination with Gladstone's leadership and experience should allow them to make excellent new investments in this market, which should outweigh what I expect to be modest impairment to GAIN's net asset value. I attended GAIN's annual shareholder meeting and talked with David Gladstone himself, and feel that GAIN should perform well in the upcoming quarters.

Highland Distressed Opportunities (HCD) is a relatively new BDC created with the express purpose of focusing on distressed businesses. A colleague of mine has spoken at length with a managing director at HCD to learn about their strategy. HCD is part of a syndicate of private equity entities, and the HCD principals ran another fund that achieved returns of 24% CAGR (net of fees) for about 9 years before this venture. HCD came public already fully invested and fully levered, so they are more exposed to mark-to-market impairments than other BDC's, though still I expect their impairments to be fairly modest. With a track record successfully working out distressed companies and a well-heeled sponsor, HCD seems well positioned to succeed in this turbulent environment. The company reports that, despite some markdowns, they think they can effectively turn over their capital and be largely invested in their desired asset base (distressed middle-market companies) by the end of 2007.

Triangle Capital Corporation (TCAP) is also a relatively new BDC, and like HCD was launched holding an existing and successful private equity shop. With a low profile and specializing in privately negotiated deals rather than syndicated debt, TCAP has access to an unusually attractive form of financing. As a registered Small Business Investment Company (SBIC), TCAP can make use of debt

guaranteed by the Small Business Administration (SBA), which is long-term low-cost debt. Perhaps most importantly in this market, this financing is plentiful, since it is backed by the SBA. I have talked at length with Steven Lilly, TCAP's CFO, and am comfortable that they will deliver substantial shareholder value in the coming quarters, though you likely won't read about them in the newspaper.

### Access National Bank

Access National Bank is a community bank and commercial and residential lender. Access operates almost exclusively in one of the best banking markets in the country. Fairfax County, where Access is based, and Loudon County, the adjacent county, were recently reported to be the #1 and #2 highest income counties in the country. Bank deposits have grown in this area at over 20% CAGR for more than 5 years, and the local economy is very strong with substantial commercial and government components.

Access focuses almost exclusively on "A" credit lending, and has virtually no exposure to sub-prime. With a low cost structure and access to a durable source of cheap financing through bank deposits, Access can achieve good profits while steering clear of lower quality business that causes headaches.

Despite its conservative stance, Access has been dealt some bad cards in its residential mortgage operation. Virtually all of the problems in 2007 have been due primarily to fraud outside of Access' organization. The impacts have been modest, and Access has been proactive in working through the problems and attaining high recoveries. Through extensive conversations with Mike Clarke, Access' CEO, I've learned the ins and outs of their mortgage operation and am very comfortable that their exposure to the credit crunch is quite manageable, and may already be subsiding.

One key advantage enjoyed by Access is a surplus of capital. They raised money in a secondary offering about a year ago, and entered 2007 significantly overcapitalized. But rather than a drawback, this proved to be a key advantage as the markets turned down. Beyond being sure of sufficient liquidity, the company has been buying back substantial amounts of their own stock and preferred securities, which will benefit shareholders in the long run. They are also continuing with branch expansion.

This buyback behavior alone should boost earnings per share by 12-15% next year. That in combination with recovery in the mortgage industry, continued strength in the local economy, and a 67% increase in branches due to be completed by the end of 2007, Access' future is bright indeed. 80% of employees are shareholders and the average stake held by executive insiders is \$3.2 million, so the employees of Access are as interested in share price performance as we are.

### **Closing**

This newsletter is unusually long, but recent events have also been unusual. Now is a good time to revisit "the big picture".

First of all, as equity investors we must always remain focused on the long term. That means at least 2-3 years for individual investments, and somewhat longer for an entire portfolio. Long-term investors have an inherent advantage over short-term investors because they can embrace uncertainty and volatility in order to find opportunities, and to follow facts instead of psychology when assessing

an investment. One thing we can expect from the equity markets is unexpected events, but this only works to our advantage if we can be patient in waiting out the bumps.

Secondly, while not committing to any particular market segment, Tidd Capital has for the past 3 years had a focus on the finance industry. We have enjoyed a series of good investments in this area, and have enjoyed pretty good results. However, even after the smoke clears from the current credit crunch, the financial environment might be a lot different over the next 5 years as the last 5. A recession is a real possibility, along with the associated devaluation of various financial assets. Returns on equity and invested capital among these companies are likely to be lower than the past, with more risk.

For these reasons, clients can expect portfolios to move away from the financial sector in the upcoming quarters, though in no way will I lower our standards. I am still looking at parts of the finance industry, and additionally I am currently looking at opportunities in energy, technology, infrastructure (domestic and international), and manufacturing. There are a lot of wonderful companies in these sectors and I feel sure that there will be some good opportunities.

I appreciate the continued trust clients place in my firm, especially during turbulent times like these. I hope that this letter has given you a better understanding of my investment process. If you have any questions or concerns, please feel free to contact me by phone or e-mail at any time.

Randall Tidd  
President, Tidd Capital  
703-652-4613  
rtidd@tiddcapital.com