

NEW CENTURY REIT INC  
Form S-3/A  
September 24, 2004  
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As filed with the Securities and Exchange Commission on September 24, 2004

Registration No. 333-114707

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

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**AMENDMENT NO. 7**  
**TO**  
**FORM S-3**  
**REGISTRATION STATEMENT**  
*UNDER THE SECURITIES ACT OF 1933*

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**NEW CENTURY REIT, INC.**

(Exact name of registrant as specified in its charter)

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**Maryland**  
(State of other jurisdiction of  
incorporation or organization)

**56-2451763**  
(I.R.S. Employer  
Identification No.)

**18400 Von Karman Avenue, Suite 1000**  
**Irvine, California 92612**

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(949) 440-7030

(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

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**Brad A. Morrice**

**President and Chief Operating Officer**

**New Century REIT, Inc.**

**18400 Von Karman, Suite 1000**

**Irvine, California 92612**

**(949) 440-7030**

*Copies to:*

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**100 Maiden Lane**

**New York, New York 10038**

**(212) 504-6000**

Approximate date of commencement of proposed sale to the public:

As soon as practicable after the effective date of this registration statement.

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If the only securities being registered on this form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. "

If any of the securities being registered on this form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box. "

If this form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. "

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If this form is a post effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. "

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. "

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### CALCULATION OF REGISTRATION FEE

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<b>Title of each class of shares to be registered</b>	<b>Proposed maximum aggregate offering price(1)(2)</b>	<b>Amount of registration fee(3)</b>
Common Stock, par value \$0.01 per share	\$162,150,000.00	\$20,544.41

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- (1) Represents the amount by which the maximum aggregate offering price of the registrant's public offering (\$1,024,650,000), including shares potentially issuable upon exercise of the underwriters' over-allotment option, exceeds the maximum aggregate offering price previously registered (\$862,500,000) pursuant to this registration statement. Pursuant to Rule 416 of the Securities Act of 1933, as amended, this registration statement also registers such additional number of shares of common stock as may become issuable as a result of stock splits, stock dividends or similar transactions.
- (2) Estimated based on a bona fide estimate of the maximum aggregate offering price solely for the purpose of calculating the registration fee pursuant to Rule 457(o) of the Securities Act of 1933, as amended.
- (3) Calculated under Section 6(b) of the Securities Act of 1933, as amended, based upon a registration fee rate of \$126.70 per \$1.0 million of proposed maximum aggregate offering price.

**The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the registration statement shall become effective on such date as the Securities and Exchange Commission, acting pursuant to said Section 8(a), may determine.**

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The information in this preliminary prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This preliminary prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

PRELIMINARY PROSPECTUS

Subject to completion

SEPTEMBER 24, 2004

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## 13,500,000 Shares

## Common Stock

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New Century REIT, Inc. is a mortgage finance company that was recently formed to continue and expand the business of New Century Financial Corporation, or New Century Financial. We expect to qualify as a real estate investment trust, or REIT, for U.S. federal income tax purposes commencing with our taxable year ending December 31, 2004.

We are offering 13,500,000 shares of our common stock in this offering. No public market currently exists for our common stock.

Our common stock has been approved for listing on the New York Stock Exchange, or NYSE, under the symbol **NEW**, subject to official notice of issuance. We currently expect the public offering price to be between \$60.00 and \$66.00 per share. The common stock of New Century Financial, our predecessor, is listed on the Nasdaq National Market under the symbol **NCEN**.

Investing in our common stock involves a high degree of risk. Before buying any shares of our common stock, you should carefully consider the risk factors described in Risk factors beginning on page 13, which include the following:

- Ø the current price of New Century Financial common stock may not be indicative of the price of our common stock following this offering;
- Ø we have no operating history as a REIT, and we cannot assure you that our management's past experience will be sufficient to manage our business as a REIT;
- Ø the loans we originate and hold are subprime, rather than prime, and generally have higher delinquency and default rates than prime loans, which could result in losses on our loans;

Ø

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interest rate fluctuations resulting in our interest expense exceeding our interest income would result in operating losses for us and may limit or eliminate our ability to make distributions to you; and

Ø we may not be successful in qualifying as a REIT or maintaining our qualification as a REIT for U.S. federal income tax purposes, in which case we would be subject to U.S. federal income tax on our taxable income at regular corporate rates, thereby reducing the amount of funds available for distribution to you.

**Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.**

	Per Share	Total
Public offering price	\$	\$
Underwriting discount and commissions(1)	\$	\$
Proceeds, before expenses, to us	\$	\$

(1) Concurrent with the closing of this offering, an affiliate of Friedman, Billings, Ramsey & Co., Inc., or Friedman Billings, may purchase approximately \$35 million of shares of our common stock at a per share price equal to the public offering price in this offering less the underwriting discount. The shares in the concurrent private placement are not being registered as part of this offering and will be restricted securities. The Friedman Billings affiliate's participation in the concurrent private placement may be deemed to be underwriting compensation within the meaning of Rule 2710 of the National Association of Securities Dealers. See Underwriting.

The underwriters may also purchase up to an additional 2,025,000 shares of common stock from us at the public offering price, less underwriting discounts and commissions, within 30 days from the date of this prospectus. The underwriters may exercise the option to cover over-allotments, if any. If the underwriters exercise the option in full, the total underwriting discounts and commissions will be \$ and the total proceeds, before expenses, to us will be \$ .

We expect the shares of common stock to be sold in this offering will be delivered on or around , 2004.

**UBS Investment Bank**

**Friedman Billings Ramsey**

**Merrill Lynch & Co.**

**Morgan Stanley**

**Flagstone Securities**

**Jefferies & Company, Inc.**

**JMP Securities**

**Piper Jaffray**

The date of this prospectus is , 2004.

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**You should rely only on the information contained in this document. We have not authorized anyone to provide you with information that is different. This document may be used only where it is legal to sell these securities. The information in this document may be accurate only on the date of this document.**

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We have registered trademarks for FastQu<sup>®</sup> and New Century Mortgage, and we have a registered service mark for the New Century logo. All other brand names or trademarks appearing in this prospectus are the property of their respective holders.

Unless otherwise indicated, the statements in this prospectus assume that we have completed the merger and related transactions which are described in "The merger and related transactions" beginning on page 47.

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## Prospectus summary

*This is only a summary and does not contain all of the information that you should consider before investing in our common stock. You should also read the entire prospectus, including Risk factors and our financial statements and related notes appearing elsewhere in this prospectus, before deciding to invest in our common stock. In this prospectus, unless the context suggests otherwise, the terms our company, we, our and us refer to New Century REIT, Inc. and our predecessor, New Century Financial, which will be a subsidiary of New Century REIT after completion of the merger (as described below). New Century Financial refers to New Century TRS Holdings, Inc., one of our wholly-owned taxable REIT subsidiaries and a successor to New Century Financial, and its subsidiaries. Unless otherwise indicated, the information contained in this prospectus assumes that the shares of our common stock offered pursuant to this prospectus are sold at a public offering price of \$63.00 per share, which is the midpoint of the price range set forth on the cover page of this prospectus.*

### OVERVIEW

We are the nation's second largest subprime mortgage finance company in terms of loan volume. We originate, purchase, retain, sell and service primarily first mortgage products to borrowers nationwide. We focus on lending to individuals whose borrowing needs are generally not fulfilled by traditional financial institutions because they do not satisfy the customary credit, documentation or other underwriting standards prescribed by conventional mortgage lenders and loan buyers, such as Fannie Mae and Freddie Mac. We originate and purchase these loans on the basis of the borrower's ability to repay the mortgage loan, the borrower's historical pattern of debt repayment and the amount of equity in the borrower's property (as measured by the borrower's loan-to-value ratio, or LTV). We have been originating and purchasing subprime loans since 1996 and believe we have developed a comprehensive and sophisticated process of credit evaluation and risk-based pricing that allows us to effectively manage the potentially higher credit risks associated with this segment of the mortgage industry.

Historically, we have sold our loans through both whole loan sales and, beginning in 1997, securitizations structured as sales, whereby we continue to manage the portfolio of mortgage loans because we retain a residual interest in the loans. In January 2003, we began to structure our securitization transactions as financings and, as a result, we have begun to retain a portion of our loan production on our balance sheet to build a loan portfolio to generate interest income. As we continue to accumulate mortgage assets in our portfolio, we expect that the proportion of our earnings generated by our portfolio will increase relative to earnings generated by our mortgage banking operations. We believe that after we qualify as a REIT, this strategy will provide us with a more diversified earnings stream in a tax-efficient manner while allowing us to continue to operate a growing mortgage origination franchise. In addition, our servicing platform was recently rated RPS3, or average, by Fitch Ratings, Inc., or Fitch, and rated average by Standard & Poor's, or S&P, which we believe will allow us to expand our servicing portfolio of loans serviced for third parties. For the first full quarter after the consummation of the merger, we expect that approximately 80% of our pretax earnings will be generated by our taxable REIT subsidiaries and will be subject to taxation at regular corporate rates. We expect that this percentage will decrease over time as we continue to build our portfolio of mortgage loans held for investment. We expect that our taxable REIT subsidiaries will be able to retain some or all of the after-tax earnings they generate to provide for our future growth and may, from time to time, distribute a portion of these earnings to us and, subsequently, to our stockholders, depending on, among other factors, then-current market conditions and our reinvestment opportunities.

According to Inside B&C Lending, an industry trade publication, we were the second largest originator of subprime loans in 2003. During that year, we originated over \$27 billion of mortgage loans, \$8.3 billion of which were originated in the fourth quarter of 2003. We experienced a

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compounded annual growth rate in our origination volume of 87.6% from 2000 to 2003, and had a market share of 8.3% for the year ended December 31, 2003 compared to 3.0% for the year ended December 31, 2000. In the first half of 2004, we originated \$20.7 billion of mortgage loans. Approximately 62% of our mortgage production for the first half of the year consisted of cash-out refinancings, where the borrowers refinanced their existing mortgages and received cash representing a portion of the equity in their homes. For the same period, approximately 32% of our mortgage production was represented by home purchase finance loans. The remainder of our mortgage production was represented by transactions in which borrowers refinanced their existing mortgages to obtain a better interest rate or loan maturity, or rate and term refinance transactions.

We seek to manage the risks associated with the subprime segment of the mortgage industry in a number of ways, including: (i) periodic updating of our underwriting criteria and processes using the latest technology available and investor feedback; (ii) a comprehensive quality assurance program; and (iii) a team of financial analysts who take into account our database of loan performance data and the current economic and interest rate environments to seek to predict the future performance of like pools of loans.

As of June 30, 2004 and December 31, 2003, the delinquency rates on outstanding mortgage loans that were 60 days or more past due and that we previously securitized in either on-balance sheet or off-balance sheet transactions were 3.27% and 6.18%, respectively. As the loans to which these delinquency rates relate continue to age, we expect that the delinquency rate will approach our historical average range of approximately 10% to 20%. Ultimately, we expect that approximately two-thirds of these loans will result in losses with a severity of approximately 40%. Loss severity represents the percentage shortfall of the expected collections on a mortgage loan versus the amount we actually recovered. As a result, we expect the cumulative pool loss rate on the loans we have securitized in on- or off-balance sheet securitizations to range from approximately 3% to 5%. Cumulative pool loss rates are defined as the total losses over the life of a securitization pool divided by the aggregate original principal balance of the mortgage loans in the pool.

We had approximately 4,600 employees as of June 30, 2004. New Century Financial common stock has been quoted on the Nasdaq National Market under the symbol **NCEN** since its initial public offering in June 1997. Our principal executive offices are located at 18400 Von Karman Avenue, Suite 1000, Irvine, California 92612, our telephone number at that location is (949) 440-7030 and our website is [www.ncen.com](http://www.ncen.com). Information contained on our website does not constitute a part of this prospectus.

## **BUSINESS STRATEGY**

Our business objective is to pursue growth while also seeking to provide more stable, predictable earnings even when the origination environment becomes less favorable. We intend to execute this strategy by:

- Ø strengthening our production franchise by expanding our total loan production and increasing market share and volume on the East Coast and in other metropolitan areas outside of California;
- Ø growing our portfolio of mortgage-related assets by retaining self-originated loans through on-balance sheet securitizations, which we believe will increase net interest income and reduce our reliance on our origination franchise to grow earnings;
- Ø strengthening our balance sheet by increasing our liquidity and capital position with the net proceeds from this offering and future offerings and by increasing available capacity under our lines of credit. We believe these efforts will better protect our franchise and provide the ability to respond to disruptions in the market or other adverse conditions and allow us to meet the REIT distribution and other qualification requirements;





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- Ø actively managing the interest rate and credit risks relating to our portfolio of mortgage-related assets in an effort to generate an attractive risk-adjusted return on our stockholders' equity;
- Ø expanding our servicing platform by taking advantage of our technical capabilities, capitalization and economies of scale; and
- Ø diversifying our revenues by evaluating and executing strategic acquisitions and new business opportunities.

## **COMPETITIVE ADVANTAGES**

We believe that the following competitive strengths distinguish our business model from those of other residential mortgage lenders and REITs and will enable us to implement our business strategy:

- Ø we are the nation's second largest subprime mortgage finance company when measured by loan production volume, with a wholesale network of approximately 31,200 approved independent mortgage brokers and a retail network of 74 branch offices in 29 states;
- Ø our structure and business strategy provide us with the flexibility to both securitize a portion of our loan originations for our portfolio and sell the balance for cash, which we believe allows us to provide a broader product offering, better manage our cash flows and respond to the secondary market environment, thus enhancing the return on our stockholders' equity;
- Ø we have developed long-standing relationships with a variety of institutional loan buyers, including Bear Stearns, Credit Suisse First Boston, Deutsche Bank, Goldman Sachs, Morgan Stanley and UBS Real Estate Securities. These loan buyers regularly bid on and purchase large loan pools from us and we frequently enter into committed forward loan sale agreements with them. We also have lending relationships with a variety of institutional lenders, including Bank of America, Bear Stearns, CDC Mortgage Capital, Citigroup Global Markets, Morgan Stanley and UBS Real Estate Securities;
- Ø unlike mortgage REITs without origination capabilities, we believe our ability to originate loans through one or more of our qualified REIT subsidiaries and purchase loans originated by one or more of our taxable REIT subsidiaries will allow us to accumulate mortgage loans at a lower cost and with greater reliability than would be available through secondary market purchases;
- Ø we have created a proprietary automated credit grading and pricing methodology that we believe, based upon our historical loan performance, gives us the ability to more effectively evaluate credit risk and more efficiently price our products and which we believe enables us to generate attractive risk-adjusted returns as a result;
- Ø we believe our origination process is easier for our borrowers and brokers to use because of our ability to provide prompt responses and consistent and clear procedures, with an emphasis on ease of use through technology, including our FastQual® system, a Web-based underwriting engine; and
- Ø the members of our senior management team have, on average, over 20 years of experience in the mortgage finance sector, with substantial experience addressing the challenges posed by a variety of interest rate environments, including growing an origination franchise, managing credit risk and developing strong capital market relationships.

## **THE RESIDENTIAL MORTGAGE MARKET**

The residential mortgage market is the largest consumer finance market in the United States. According to the Mortgage Bankers Association of America, or the MBA, lenders in the United States originated over \$3.8 trillion of single-family mortgage loans in 2003 and the MBA is predicting originations of \$2.5 trillion in 2004. The residential mortgage market can generally be bifurcated into conforming and non-conforming mortgage loans. Non-conforming mortgage loans are those mortgage loans generally not

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eligible for sale to Fannie Mae or Freddie Mac due to size and/or credit characteristics. Our loan production focuses on the subprime mortgage segment of the non-conforming market, which consists of loans that generally do not satisfy the credit characteristics of the conforming market.

According to Inside B&C Lending, the subprime mortgage market volume was approximately \$332 billion in 2003, which represented approximately 9% of the overall residential mortgage market. The subprime mortgage market has grown from \$34 billion in 1994 to \$332 billion in 2003, representing a 29% compounded annual growth rate, while the overall single-family residential mortgage market has grown from \$769 billion in 1994 to \$3.8 trillion in 2003, representing a compounded annual growth rate of 19%.

In addition to faster growth, the subprime mortgage market has historically focused on home purchases and cash-out refinancings, rather than interest rate driven refinancings, which have caused this market segment to be less interest rate sensitive, and therefore less volatile, than the prime mortgage market. For example, for the 10 quarters ended June 30, 2004, the prime loan origination market experienced substantial volatility with a peak quarterly growth rate of approximately 52.2% in the second quarter of 2003, and a peak quarterly decline of approximately 51.9% in the fourth quarter of 2003. In contrast, during the same period the subprime loan origination market experienced a peak growth rate of approximately 39.2% in the second quarter of 2004, did not decline at all during that period and experienced the lowest quarterly increase of approximately 1.6% in the first quarter of 2003. In addition, the subprime market has shown an ability to grow during volatile interest rate environments, as indicated by the subprime market's growth by an average of 16.7% over the three quarters ended June 30, 2004, in contrast to the prime market's decline by an average of 2.3% over these same periods.

## **OUR REIT STATUS**

New Century REIT is a Maryland corporation formed by New Century Financial on April 12, 2004 to succeed to and continue the business of New Century Financial upon completion of the merger of NC Merger Sub, Inc., a wholly-owned subsidiary of New Century REIT, with and into New Century Financial. To date, New Century REIT has not conducted any activities other than those incident to its formation, the execution of the merger agreement and the preparation of this prospectus. Following completion of the merger, New Century REIT will be renamed New Century Financial Corporation. New Century REIT expects to qualify as a REIT for U.S. federal income tax purposes commencing with its taxable year ending December 31, 2004.

## **THE MERGER AND RELATED TRANSACTIONS**

On September 15, 2004, New Century Financial stockholders approved and adopted the merger agreement. Upon completion of the merger of NC Merger Sub with and into New Century Financial, each outstanding share of New Century Financial common stock will be converted into one share of our common stock. The rights of our stockholders will be governed by the Maryland General Corporation Law, or MGCL, as well as our charter and bylaws. New Century REIT will be renamed New Century Financial Corporation, will become the parent company of New Century Financial and will succeed to and continue to operate, directly or indirectly, substantially all of the existing businesses of New Century Financial. New Century Financial will be renamed New Century TRS Holdings, Inc. and will become a wholly-owned taxable REIT subsidiary of New Century REIT. The board of directors, committees of the board of directors and management of New Century Financial immediately prior to the merger will become our board of directors, committees of the board of directors and management. We will also assume all of New Century Financial's stock incentive plans and all rights to acquire shares of New Century Financial common stock under any New Century Financial stock incentive plan will be

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converted into rights to acquire shares of our common stock pursuant to the terms of the stock incentive plans and the other related documents, if any.

We have structured the merger to qualify as a tax-free reorganization for U.S. federal income tax purposes. If the merger so qualifies, no gain or loss will be recognized by New Century Financial, New Century REIT or NC Merger Sub as a result of the merger.

## **SUMMARY RISK FACTORS**

An investment in our common stock involves a high degree of risk. The Risk factors section of this prospectus which begins on page 13 contains a detailed discussion of our most important risks, including, but not limited to, the risks summarized below.

- Ø the current price of New Century Financial common stock may not be indicative of the price of our common stock following this offering;
- Ø we have no operating history as a REIT, and we cannot assure you that our management's past experience will be sufficient to manage our business as a REIT;
- Ø the loans we originate and hold are subprime, rather than prime, and generally have higher delinquency and default rates than prime loans, which could result in losses on our loans;
- Ø the geographic concentration of our mortgage loan originations increases our exposure to risks in those areas, especially California, where approximately 41.3% of the aggregate principal amount of our mortgage loans were secured by property located in that state;
- Ø adverse economic conditions or declining real estate values could harm our operations;
- Ø interest rate fluctuations resulting in our interest expense exceeding our interest income would result in operating losses for us and may limit or eliminate our ability to make distributions to you; and
- Ø we may not be successful in qualifying as a REIT or maintaining our qualification as a REIT for U.S. federal income tax purposes, in which case we would be subject to U.S. federal income tax on our taxable income at regular corporate rates, thereby reducing the amount of funds available for making distributions to you.

## **DISTRIBUTION POLICY**

We intend to distribute each year all, or substantially all, of the REIT taxable income generated by us in order to qualify for the tax benefits accorded to REITs under the Internal Revenue Code. From time to time, we may also distribute some or all of the after-tax earnings retained in our taxable REIT subsidiaries to our stockholders, depending on, among other factors, then-current market conditions and our reinvestment opportunities. We expect to declare regular quarterly distributions to our stockholders beginning in the fourth quarter of 2004.

In order to qualify as a REIT, we must distribute to our stockholders at least 90% of our REIT taxable income (determined without regard to the dividends paid deduction and by excluding net capital gain) each year. After-tax earnings generated by our taxable REIT subsidiaries and not distributed to us are not subject to these distribution requirements and may be retained by such subsidiaries to provide for future growth, subject to the limitations imposed by REIT tax rules. To the extent that we distribute at least 90%, but less than 100% of our REIT taxable income in a taxable year, we will be subject to U.S. federal corporate income tax on our undistributed income. In addition, if we fail to distribute an amount during each year equal to the sum of 85% of our REIT ordinary income and 95% of our capital gain net income for that year and any undistributed income from prior periods, we will be subject to a 4% nondeductible excise tax on the excess of the required distribution over the amount we actually distributed. See Material U.S. federal income tax consequences.

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In addition, in connection with the merger and the other restructuring activities necessary for us to qualify as a REIT, we may, if necessary, declare an immaterial one-time special distribution of the current and accumulated earnings and profits of New Century Credit Corporation, or New Century Credit, which is currently an indirect wholly-owned subsidiary of New Century Financial, to our stockholders payable in cash, or the special E&P distribution, in December 2004. If required, we will make this one-time distribution in January 2005 to our stockholders on the record date for such distribution. The investors in this offering will be eligible to receive the special E&P distribution if those investors hold our common stock on the applicable record date.

## **RESTRICTIONS ON OWNERSHIP OF OUR COMMON STOCK**

In order to assist us in maintaining our qualification as a REIT under the Internal Revenue Code, our charter contains restrictions on the number of shares of our capital stock that a person may own. No person may acquire or hold, directly or indirectly, in excess of 9.8% in value or in number of shares, whichever is more restrictive, of the aggregate of the outstanding shares of any class or series of our capital stock. These ownership limits could delay, defer or prevent a transaction or a change in control that might involve a premium price for our common stock or otherwise be in your best interest. Our board of directors may, in its sole discretion, waive the ownership limit with respect to a particular stockholder if it is presented with evidence satisfactory to it that the ownership of that stockholder will not then or in the future jeopardize our status as a REIT. See Description of our capital stock Transfer restrictions.

## **PRIVATE PLACEMENT**

Concurrent with the closing of this offering, we plan to make a private placement of approximately \$35 million of shares of our common stock to an affiliate of Friedman Billings at a per share price equal to the public offering price in this offering less the underwriting discount. We refer to this private offering as the concurrent private placement. If we assume the per share price in the concurrent private placement is equal to the midpoint of the price range set forth on the cover page of this prospectus less the underwriter discount, then the concurrent private placement will consist of 586,338 shares of our common stock. We expect we will enter into a registration rights agreement with the affiliate of Friedman Billings and will agree to register the resale of the shares that the affiliate of Friedman Billings purchases in the concurrent private placement. We also expect that we will enter into a lock-up agreement with the affiliate relating to these shares. See Underwriting. This offering is not conditioned on the concurrent private placement and there is no assurance that the concurrent private placement will be consummated.

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## The offering

Common stock offered by us	13,500,000 shares <sup>(1)</sup>
Common stock to be outstanding after this offering	47,567,884 shares <sup>(1)(2)</sup>
Use of proceeds	We intend to use the net proceeds of this offering and the concurrent private placement, which are estimated to be approximately \$837.3 million, based on (1) the sale of 13,500,000 shares of our common stock at an assumed public offering price of \$63.00 per share, which is the midpoint of the price range set forth on the cover page of this prospectus, after deducting the underwriting discount and estimated offering expenses of approximately \$3.5 million payable by us and (2) the concurrent private placement of approximately \$35 million of shares of our common stock to an affiliate of Friedman Billings at a per share price equal to the assumed public offering price less the underwriting discount, primarily for general working capital purposes, including to build a portfolio of self-originated mortgage loans and, if necessary to maintain our REIT status, to purchase mortgage-related assets from third parties.
Risk factors	See Risk factors and other information included in this prospectus for a discussion of some of the factors you should carefully consider before deciding whether to purchase our common stock.
Trading symbol	Our common stock has been approved for listing on the NYSE under the symbol NEW, subject to official notice of issuance.

(1) Assumes that the underwriters' over-allotment option to purchase up to an additional 2,025,000 shares will not be exercised and excludes 586,338 shares of our common stock issuable to an affiliate of Friedman Billings in the concurrent private placement.

(2) The common stock to be outstanding after this offering is based on 34,047,884 shares of our common stock issuable to New Century Financial stockholders in connection with the merger as of August 31, 2004 and excludes:

∅ a total of 5,342,736 shares of our common stock issuable upon the exercise of stock options outstanding on August 31, 2004 with a weighted-average exercise price of \$18.26 per share;

∅ a total of 591,225 shares of our common stock available for awards under our stock incentive plans as of August 31, 2004;

∅ up to 6,034,686 shares of common stock issuable as of August 31, 2004 upon the conversion of our 3.50% convertible senior notes due 2008 (subject to adjustments under the terms of the convertible notes); and

∅ up to 6,034,668 shares of common stock issuable as of August 31, 2004 upon the exercise of a warrant issued in connection with the issuance of the convertible notes.



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## Summary historical financial data of New Century Financial

You should read the following summary of historical financial data in conjunction with New Century Financial's historical consolidated financial statements and related notes thereto and Management's discussion and analysis of financial condition and results of operations, which are included elsewhere or incorporated by reference in this prospectus.

The historical financial data set forth below reflects our business strategy before the merger and the other restructuring activities necessary for us to qualify as a REIT. Accordingly, our historical financial results will not be indicative of our future performance (in part due to our expected strategy of increasing our portfolio of mortgage loans originated by one or more of our taxable REIT subsidiaries, which will proportionately reduce the number of loans we sell to third-party investors and which may cause our total gains on sale under generally accepted accounting principles to be lower than we have historically recognized). We have not presented historical financial information for New Century REIT because it was formed on April 12, 2004 and has had minimal operations since then.

The summary historical balance sheet and statement of operations data for the years ended December 31, 2003, 2002 and 2001 of New Century Financial have been derived from the historical financial statements of New Century Financial audited by KPMG LLP, our Independent Registered Public Accounting Firm, whose report with respect thereto is included elsewhere in this prospectus. The financial data for the six months ended June 30, 2004 and 2003 were derived from our unaudited consolidated financial statements and include, in the opinion of management, all normal and recurring adjustments necessary to present the data fairly for such periods. Such selected financial data should be read in conjunction with those financial statements and the notes thereto and with Management's discussion and analysis of financial condition and results of operations also included elsewhere herein.

Statement of operations data:	For the Six Months Ended June 30,		For the Years Ended December 31,		
	2004	2003	2003	2002	2001
	(dollars in thousands, except per share data)				
Revenues:					
Gain on sales of loans	\$ 417,027	\$ 272,084	\$ 611,136	\$ 451,744	\$ 182,612
Interest income(1)	334,905	105,863	329,463	122,331	62,706
Residual interest income	9,358	12,684	24,228	31,723	36,356
Servicing income	13,649	5,821	11,139	432	10,616
Other income	829			16	1,046
Total revenues	775,768	396,452	975,966	606,246	293,336
Expenses(1)	456,915	214,261	552,714	299,910	209,852
Earnings before income taxes	318,853	182,191	423,252	306,336	83,484
Income taxes	129,231	75,637	177,769	126,636	35,464
Net earnings	\$ 189,622	\$ 106,554	\$ 245,483	\$ 179,700	\$ 48,020
Basic earnings per share	\$ 5.72	\$ 3.11	\$ 7.26	\$ 5.19	\$ 1.83
Diluted earnings per share	\$ 4.46	\$ 2.83	\$ 6.56	\$ 4.62	\$ 1.52

(1) Interest income for the six months ended June 30, 2004 and 2003 includes \$176.8 million and \$15.9 million, respectively, related to interest earned on mortgage loans receivable held for investment. Expenses for the six months ended June 30, 2004 and 2003 include

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\$66.4 million and \$4.5 million, respectively, related to interest expense on financing of mortgage loans held for investment and \$37.0 million and \$7.7 million, respectively, related to the provision for loan losses

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on mortgage loans held for investment. Interest income for the year ended December 31, 2003 includes \$104.7 million related to interest earned on mortgage loans receivable held for investment. Expenses for that period include \$36.7 million related to interest expense on financing of mortgage loans held for investment and \$26.3 million related to the provision for loan losses on mortgage loans held for investment.

Other data:	For the Six Months Ended June 30,		For the Years Ended December 31,		
	2004	2003(1) (dollars in thousands, unless otherwise stated)	2003(1)	2002	2001
Purchases	\$6,703,353	\$2,200,161	\$ 6,858,645	\$ 2,535,675	\$ 1,071,150
Refinances:					
Cash out refinances	12,850,155	6,636,318	17,587,036	9,397,259	4,144,887
Rate/term refinances	1,138,715	1,655,989	2,937,157	2,268,562	1,028,934
Total originations	20,692,223	10,492,468	27,382,838	14,201,496	6,244,971
Fixed-rate mortgages	6,659,613	2,617,379	8,197,321	3,708,938	1,143,188
Adjustable-rate mortgages	14,032,610	7,875,089	19,185,517	10,492,558	5,101,783
Total originations	20,692,223	10,492,468	27,382,838	14,201,496	6,244,971
Wholesale	18,781,248	9,561,251	25,187,569	12,392,562	5,068,466
Retail	1,910,975	931,217	2,195,269	1,808,934	1,176,505
Total originations	20,692,223	10,492,468	27,382,838	14,201,496	6,244,971
Weighted average FICO score of loans originated	628	598	612	597	587
Average principal balance of loans originated	\$ 172	\$ 159	\$ 167	\$ 151	\$ 138
Weighted average interest rates:					
Fixed-rate mortgages	7.0%	7.9%	7.3%	8.2%	9.5%
Adjustable-rate mortgages initial rate	6.8%	7.5%	7.3%	8.3%	9.4%
Adjustable-rate mortgages margin over index	5.5%	5.8%	5.8%	6.6%	6.6%
Percentage of loans originated in top two credit grades	86.3%	76.3%	81.1%	58.7%	48.4%
Percentage of loans originated in bottom two credit grades	3.0%	3.6%	3.3%	4.8%	8.1%
Number of retail branch offices at period end	74	68	72	66	65
Number of regional operating centers at period end	26	19	20	19	5
Number of employees at period end	4,624	2,973	3,752	2,487	1,531
Total whole loan sales	\$ 13,803,821	\$ 9,036,341	\$ 20,835,105	\$ 12,419,687	\$ 4,723,350
Total securitizations structured as sales	337,148			845,477	898,244
Total securitizations structured as financings	3,457,776	1,206,015	4,946,781		
Total secondary market transactions	17,598,745	10,242,356	25,781,886	13,265,164	5,621,594
Weighted average premium on whole loan sales	4.04%	4.28%	4.18%	4.37%	4.40%

(1) Certain amounts for prior year s presentation have been reclassified to conform to the current year presentation.

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Balance sheet data:	As of June 30,		As of December 31,		
	2004	2003	2003 (dollars in thousands)	2002	2001
Cash and equivalents	\$ 68,891	\$ 169,085	\$ 269,540	\$ 176,669	\$ 100,263
Restricted cash	322,369	22,732	116,883	6,255	6,416
Mortgage loans held for sale, net	4,784,222	2,138,347	3,422,211	1,920,396	1,011,122
Mortgage loans held for investment, net	9,146,472	1,187,617	4,745,937		
Residual interests in securitizations	190,827	211,469	179,498	246,964	306,908
Other assets	220,929	66,611	200,811	52,644	26,609
<b>Total assets</b>	<b>14,733,710</b>	<b>3,795,861</b>	<b>8,934,880</b>	<b>2,402,928</b>	<b>1,451,318</b>
Credit facilities	4,439,518	2,049,572	3,311,837	1,885,498	987,568
Financing on mortgage loans held for investment, net	9,086,932	1,161,299	4,686,323		
Convertible notes, net	205,349		204,858		
<b>Residual financing</b>					<b>79,941</b>
Subordinated debt					40,000
Other liabilities	258,574	115,153	189,851	130,880	96,048
<b>Total liabilities</b>	<b>13,990,373</b>	<b>3,326,024</b>	<b>8,392,869</b>	<b>2,016,378</b>	<b>1,203,557</b>
Total stockholders' equity	743,337	469,837	\$ 542,011	\$ 386,550	\$ 247,761

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## Risk factors

*You should carefully consider the risks described below before making an investment decision. Our results of operations, financial condition and business prospects could be harmed by any of these risks. This prospectus and the documents incorporated herein by reference also contain forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including the risks faced by us described below and elsewhere in this prospectus and in documents incorporated by reference into this prospectus. The trading price of our common stock could decline due to any of these risks, and you may lose all or part of your investment.*

### **RISKS RELATED TO OUR BUSINESS**

**We are dependent on external sources of financing, and if we are unable to maintain adequate financing sources, our earnings and our financial position will suffer and jeopardize our ability to continue operations.**

To qualify as a REIT under the Internal Revenue Code, we generally are required each year to distribute to our stockholders at least 90% of our REIT taxable income (determined without regard to the dividends paid deduction and by excluding net capital gains). After-tax earnings generated by our taxable REIT subsidiaries and not distributed to us are not subject to these distribution requirements and may be retained by such subsidiaries to provide for future growth, subject to the limitations imposed by REIT tax rules. Immediately after this offering, a substantial amount of our business will be conducted through our taxable REIT subsidiaries. We cannot assure you that we will have access to funds to meet the distribution and other REIT qualification requirements. We may be required to borrow funds from one of our corporate subsidiaries or a third party on a short-term basis or liquidate investments to meet the distribution requirements that are necessary to qualify as a REIT, even if management believes that it is not in our best interests to do so. If we do not have access to the necessary funds, we may have to raise capital at inopportune times or borrow funds on unfavorable terms.

In addition, we require substantial cash to support our operating activities and growth plans in our taxable REIT subsidiaries. Our primary sources of cash for our loan origination activities are our warehouse and aggregation credit facilities, our asset-backed commercial paper facility and the proceeds from the sales and securitizations of our loans. From time to time, we finance our residual interests in securitization transactions through the sale of net interest margin securities, or NIMS; however, we have not recently relied on NIMS financing as much as we have in prior years. As of June 30, 2004, we had nine short-term warehouse and aggregation credit facilities and our asset-backed commercial paper facility providing us with approximately \$8.6 billion of committed and \$2.0 billion of uncommitted borrowing capacity to fund loan originations and purchases pending the pooling and sale of such loans. If we cannot maintain or replace these facilities on comparable terms and conditions, we may incur substantially higher interest expense that would reduce our profitability.

During volatile times in the capital and secondary markets, access to warehouse, aggregation and residual financing as well as access to the securitization and secondary markets for the sale of our loans has been severely constricted. Subject to the limitations imposed by REIT tax rules, our taxable REIT subsidiaries are permitted to retain the after-tax income they generate. We may, at some point in the future, borrow funds from one or more of our corporate subsidiaries upon terms that are similar to those that would be required by a third-party lender, or actually obtain a third-party loan for some portion of the required financing amount and then replicate the third-party loan terms in the intercompany



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borrowing. However, if we are unable to maintain adequate financing or other sources of capital are not available, we would be forced to suspend or curtail our operations, which would harm our results of operations, financial condition and business prospects.

In addition, the completion of the merger will require us to obtain the consent of various parties to several of the financing agreements. Our inability to obtain the requisite consents could harm our results of operations, financial condition and business prospects and require us to seek new financing relationships. We cannot assure you that we will be able to obtain such financing relationships on terms favorable to us.

**Our management has limited experience operating a REIT and we cannot assure you that our management's past experience will be sufficient to successfully manage our business as a REIT.**

The requirements for qualifying as a REIT are highly technical and complex. We have never operated as a REIT and our management has limited experience in complying with the income, asset and other limitations imposed by the REIT provisions of the Internal Revenue Code. Those provisions are complex and the failure to comply with those provisions in a timely manner could prevent us from qualifying as a REIT or could force us to pay unexpected taxes and penalties. In such event, our net income would be reduced and we could incur a loss, which could harm our results of operation, financial condition and business prospects.

**If we are unable to accumulate sufficient REIT qualifying assets such that the value of our investment in our taxable REIT subsidiaries is not more than 20% of the value of our total assets at the close of our first taxable quarter following the merger, we will not qualify as a REIT.**

To qualify as a REIT, not more than 20% of the value of our total assets may be represented by the securities of one or more taxable REIT subsidiaries at the close of any calendar quarter. As of June 30, 2004, substantially all of our assets were REIT qualifying assets. However, for a variety of reasons, we may be unable to accumulate sufficient REIT qualifying assets such that the value of our investment in our taxable REIT subsidiaries is not more than 20% of the value of our total assets at the close of our first taxable quarter following the merger. For example:

- Ø we may not have enough capital, including net proceeds from this offering and borrowings under our credit facilities, to acquire REIT qualifying assets;
- Ø the value of our taxable REIT subsidiaries may be greater than our current expectations; or
- Ø there may be insufficient REIT qualifying assets available for purchase on reasonable terms.

If the Internal Revenue Service determines that the value of our investment in New Century Financial and other taxable REIT subsidiaries is more than 20% of the value of our total assets at the close of our first taxable quarter following the merger, we could lose our REIT status. See also Tax risks related to our status as a REIT We may not qualify as a REIT if the value of our investment in our taxable REIT subsidiaries exceeds 20% of the value of our total assets at the close of any calendar quarter.





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**A prolonged economic slowdown or a lengthy or severe recession could harm our operations, particularly if it results in a decline in the real estate market.**

The risks associated with our business are more acute during periods of economic slowdown or recession because these periods may be accompanied by decreased demand for consumer credit and declining real estate values. Declining real estate values reduce the ability of borrowers to use home equity to support borrowings because they reduce the LTV of the home equity collateral. In addition, because we make a substantial number of loans to credit-impaired borrowers, the actual rates of delinquencies, foreclosures and losses on these loans could be higher during economic slowdowns. Any sustained period of increased delinquencies, foreclosures or losses could harm our ability to sell loans, the prices we receive for our loans, or the values of our mortgage loans held for investment or our residual interests in securitizations, which could harm our results of operations, financial condition and business prospects.

**Our earnings may decrease because of increases or decreases in interest rates.**

Our profitability may be directly affected by changes in interest rates. The following are some of the risks we face related to an increase in interest rates:

- Ø An interest rate increase may harm our earnings by reducing the spread between the interest we receive on our mortgage loans and our funding costs.
- Ø A substantial and sustained increase in interest rates could harm our loan origination volume because refinancings of existing loans, including cash-out refinancings and interest rate-driven refinancings, would be less attractive and qualifying for a purchase loan may be more difficult. Lower origination volume may harm our earnings by reducing origination income, net interest income and gain on sale of loans.
- Ø During periods of rising interest rates, the value and profitability of our loans may be harmed between the date of origination or purchase until the date we sell or securitize the loans.
- Ø When we securitize loans, the value of the residual interests we retain and the income we receive from the securitizations structured as financings are based primarily on the London Inter-Bank Offered Rate, or LIBOR. This is because the interest on the underlying mortgage loans is based on fixed rates payable on the underlying loans for the first two or three years from origination while the holders of the applicable securities are generally paid based on an adjustable LIBOR-based yield. Therefore, an increase in LIBOR reduces the net income we receive from, and the value of, these mortgage loans and residual interests.
- Ø Our adjustable-rate mortgage loans have periodic and lifetime interest rate caps above which the interest rate on the loans may not rise. In the event of general interest rate increases, the rate of interest on these mortgage loans could be limited, while the rate payable on the senior certificates representing interests in a securitization trust into which these loans are sold may be uncapped. This would reduce the amount of cash we receive over the life of the loans in securitizations structured as financings and our residual interests, and could require us to reduce the carrying value of our residual interests.

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We are also subject to risks from decreasing interest rates. For example, a significant decrease in interest rates could increase the rate at which loans are prepaid, which also could require us to reduce the carrying value of our residual interests. Moreover, if prepayments are greater than expected, the cash we receive over the life of our residual interests would be reduced. Higher-than-expected prepayments could also harm the value of our servicing portfolio. Therefore, any such changes in interest rates could harm our results of operations, financial condition and business prospects.

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#### **Our reliance on cash-out refinancings as a significant source of our origination volume increases the risk that our earnings will be harmed if the demand for this type of refinancing declines.**

During the six months ended June 30, 2004, approximately 62% of our loan production volume consisted of cash-out refinancings. Our reliance on cash-out refinancings as a significant source of our origination volume increases the risk that our earnings will be harmed if interest rates rise and the prices of homes decline, which would reduce the demand and production volume for this type of refinancing. A substantial and sustained increase in interest rates could significantly reduce the number of borrowers who would qualify or elect to pursue a cash-out refinancing and result in a decline in that origination source. Similarly, a decrease in home prices would reduce the amount of equity available to be borrowed against in cash-out refinancings and result in a decrease in our loan production volume from that origination source. Therefore, our reliance on cash-out refinancings as a significant source of our origination volume could harm our results of operations, financial condition and business prospects.

#### **The loans we originate and hold are subprime, rather than prime, and generally have delinquency and default rates higher than prime loans, which could result in higher loan losses.**

Subprime mortgage loans generally have higher delinquency and default rates than prime mortgage loans. Delinquency interrupts the flow of projected interest income from a mortgage loan, and default can ultimately lead to a loss if the net realizable value of the real property securing the mortgage loan is insufficient to cover the principal and interest due on the loan. Also, our cost of financing and servicing a delinquent or defaulted loan is generally higher than for a performing loan. We bear the risk of delinquency and default on loans beginning when we originate them. In whole loan sales, our risk of delinquency typically only extends to the first payment, but when we securitize any of our loans, we continue to be exposed to delinquencies and losses through our residual interests and the loans underlying our on-balance sheet securitization transactions. We are required to establish reserves based on our anticipated delinquencies and losses. We also re-acquire the risks of delinquency and default for loans that we are obligated to repurchase. We attempt to manage these risks with risk-based loan pricing and appropriate underwriting policies and loan collection methods. However, we cannot assure you that such management policies will be successful and, if such policies and methods are insufficient to control our delinquency and default risks and do not result in appropriate loan pricing and appropriate loss reserves, our business, financial condition, liquidity and results of operations could be harmed. As of June 30, 2004, the delinquency rate on mortgage loans that were 60 days or more past due and that we previously securitized in either on- or off-balance sheet transactions was 3.27%. The expected cumulative loss rate on these loans as of June 30, 2004 is approximately 4.0%, determined as the historical cumulative loss rates of more aged loans plus the expected cumulative loss rates on newer loans, which have experienced immaterial losses through June 30, 2004. See Our business Investment and operational policies of New Century REIT.

#### **The geographic concentration of our mortgage loan originations increases our exposure to risks in those areas, especially California.**

Over-concentration of our loan originations in any one geographic area increases our exposure to the economic and natural hazard risks associated with that area. For example, in the six months ended June 30, 2003, approximately 41.3% of the aggregate principal amount of our mortgage loans were secured by property located in California. Certain parts of California have experienced an economic downturn in the past and have suffered the effects of certain natural hazards. Declines in the residential real estate markets in which we are concentrated may reduce the values of the properties collateralizing our mortgages,



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increase the risk of delinquency, foreclosure, bankruptcy, or losses and could harm our results of operations, financial condition and business prospects.

Furthermore, if borrowers are not insured for natural disasters, which are typically not covered by standard hazard insurance policies, then they may not be able to repair the property or may stop paying their mortgages if the property is damaged. A natural disaster that results in a significant number of delinquencies would cause increased foreclosures and decrease our ability to recover losses on properties affected by such disasters and would harm our results of operations, financial condition and business prospects.

Likewise, the secondary market pricing for pools of loans that are not geographically diverse is typically less favorable than for a diverse pool. Our inability to originate or purchase geographically diverse pools of loans could harm our results of operations, financial condition and business prospects.

**An interruption or reduction in the securitization and whole loan markets would harm our financial position.**

We are dependent on the securitization market for the sale of our loans because we securitize loans directly and many of our whole loan buyers purchase our loans with the intention to securitize them. The securitization market is dependent upon a number of factors, including general economic conditions, conditions in the securities market generally and conditions in the asset-backed securities market specifically. In addition, poor performance of our previously securitized loans could harm our access to the securitization market. Accordingly, a decline in the securitization market or a change in the market's demand for our loans could harm our results of operations, financial condition and business prospects.

**If we make any acquisitions, we will incur a variety of costs and may never realize the anticipated benefits.**

If appropriate opportunities become available, we may attempt to acquire businesses that we believe are a strategic fit with our business. We currently have no agreements to consummate any material acquisitions. If we pursue any such transaction, the process of negotiating the acquisition and integrating an acquired business may result in operating difficulties and expenditures and may require significant management attention that would otherwise be available for ongoing development of our business, whether or not any such transaction is ever consummated. Moreover, we may never realize the anticipated benefits of any acquisition. Future acquisitions could result in potentially dilutive issuances of equity securities, the incurrence of debt, contingent liabilities and/or amortization expenses related to goodwill and other intangible assets, which could harm our results of operations, financial condition and business prospects.

**Our earnings from holding mortgage-backed securities or government securities may be harmed by changes in the level of interest rates, changes to the difference between short and longer term interest rates, changes to the difference between interest rates for these securities compared to other debt instruments, and an absence of or reduction in the availability, at favorable terms, of repurchase financing and other liquidity sources typically utilized by mortgage REITs.**

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From time to time, we may purchase mortgage-backed securities or government securities from third parties in order to comply with the income and asset tests necessary to maintain our REIT status. The value of, and return on, the mortgage-backed securities and government securities we hold will be affected by changes in the marketplace for such securities, as well as prepayment speeds in the case of mortgage-backed securities, and may be volatile and significantly different than projected. The securities

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that we hold may produce large losses instead of the income incorporated into our projections. The impact of changes in the marketplace for these securities on our results may be magnified because these holdings could be highly leveraged. Additionally, much of the financing we will use to hold these securities may be cancelable by our lenders on short notice. If our lenders cease providing financing to us on favorable terms, we would be forced to liquidate some or all of these securities, possibly at a substantial loss, which could harm our financial condition, results of operations and business prospects.

#### **A material difference between the assumptions used in the determination of the value of our residual interests and our actual experience could harm our financial position.**

As of June 30, 2004, the value on our balance sheet of our residual interests from securitization transactions was \$190.8 million. The value of these residuals is a function of the delinquency, loss, prepayment speed and discount rate assumptions we use. It is extremely difficult to validate the assumptions we use in valuing our residual interests. In the future, if our actual experience differs materially from these assumptions, our cash flow, financial condition, results of operations and business prospects could be harmed.

#### **Our future results may materially differ from the pro forma financial information presented in this prospectus.**

Our future results may be materially different from those shown in the pro forma financial statements presented in Unaudited pro forma consolidated condensed financial information beginning on page 50. We may incur certain restructuring charges and adjustments. These charges may be higher or lower than we have estimated, depending on how costly or difficult it is to restructure our operations in order to qualify as a REIT. Furthermore, these charges may decrease our capital that could be used for profitable, income-earning investments in the future.

#### **New legislation could restrict our ability to make mortgage loans, which could harm our earnings.**

Several states and cities are considering or have passed laws, regulations or ordinances aimed at curbing predatory lending practices. The federal government is also considering legislative and regulatory proposals in this regard. In general, these proposals involve lowering the existing federal Homeownership and Equity Protection Act thresholds for defining a high-cost loan, and establishing enhanced protections and remedies for borrowers who receive such loans. However, many of these laws and rules extend beyond curbing predatory lending practices to restrict commonly accepted lending activities, including some of our activities. For example, some of these laws and rules prohibit any form of prepayment charge or severely restrict a borrower's ability to finance the points and fees charged in connection with the borrower's loan. In addition, some of these laws and regulations provide for extensive assignee liability for warehouse lenders, whole loan buyers and securitization trusts. Because of enhanced risk and for reputational reasons, many whole loan buyers elect not to purchase any loan labeled as a high cost loan under any local, state or federal law or regulation. Accordingly, these laws and rules could severely constrict the secondary market for a significant portion of our loan production. This would effectively preclude us from continuing to originate loans that fit within the newly defined thresholds. For example, after the October 1, 2002 effective date of the Georgia Fair Lending Act, our lenders and secondary market buyers refused to finance or purchase our Georgia loans. As a result, we were forced to cease providing mortgages in Georgia until the law's amendment a few months later. Similar laws have gone into effect in New Jersey, such as the New Jersey Home Ownership Act of 2002, effective as of November 27, 2003, and in New Mexico, such as the New Mexico Home Loan Protection





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Act, effective as of January 1, 2004, that have impacted our ability to originate loans in those states. The potential long-term impact could be as much as a 40% reduction in loans in New Jersey and 60% in New Mexico from previous loan origination volumes. Moreover, some of our competitors who are national banks or federally chartered thrifts may not be subject to these laws and may, therefore, be able to capture market share from us and other lenders. For example, the Office of the Comptroller of the Currency recently issued regulations effective January 7, 2004 that preempt state and local laws that seek to regulate mortgage lending practices by national banks. Passage of such state and local laws could increase compliance costs, reduce fee income and lower origination volume, all of which would harm our results of operations, financial condition and business prospects.

**We are no longer able to rely on the Alternative Mortgage Transactions Parity Act to preempt certain state law restrictions on prepayment penalties, which could harm our earnings.**

The value of a mortgage loan depends, in part, upon the expected period of time that the mortgage loan will be outstanding. If a borrower pays off a mortgage loan in advance of this expected period, the holder of the mortgage loan does not realize the full value expected to be received from the loan. A prepayment penalty payable by a borrower who repays a loan earlier than expected helps offset the reduction in value resulting from the early payoff. Consequently, the value of a mortgage loan is enhanced to the extent the loan includes a prepayment penalty, and a mortgage lender can offer a lower interest rate and/or lower loan fees on a loan which has a prepayment penalty. Prepayment penalties are an important feature used to obtain value on the loans we originate.

Certain state laws restrict or prohibit prepayment penalties on mortgage loans and, until July 2003, we relied on the federal Alternative Mortgage Transactions Parity Act, or the Parity Act, and related rules issued in the past by the Office of Thrift Supervision, or OTS, to preempt state limitations on prepayment penalties. The Parity Act was enacted to extend to financial institutions, like us, which are not federally chartered depository institutions, the federal preemption that federally chartered depository institutions enjoy. However, on September 25, 2002, the OTS released a new rule that reduced the scope of the Parity Act preemption and, as a result, we are no longer able to rely on the Parity Act to preempt state restrictions on prepayment penalties. The effective date of the new rule, originally January 1, 2003, was subsequently extended by the OTS until July 1, 2003 in response to concerns from interested parties about the burdens associated with compliance. The elimination of this federal preemption has required us to comply with state restrictions on prepayment penalties. These restrictions prohibit us from charging any prepayment penalty in eight states and limit the amount or other terms and conditions of our prepayment penalties in several other states. This may place us at a competitive disadvantage relative to financial institutions that will continue to enjoy federal preemption of such state restrictions. Such institutions are able to charge prepayment penalties without regard to state restrictions and, as a result, may be able to offer loans with interest rate and loan fee structures that are more attractive than the interest rate and loan fee structures that we are able to offer. This competitive disadvantage could harm our results of operations, financial condition and business prospects.

**The scope of our lending operations exposes us to risks of noncompliance with an increasing and inconsistent body of complex laws and regulations at the federal, state and local levels.**

Because we are authorized to originate mortgage loans in all 50 U.S. states, we must comply with the laws and regulations, as well as judicial and administrative decisions, for all of these jurisdictions, as well as an extensive body of federal law and regulations. The volume of new or modified laws and regulations



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has increased in recent years, and individual cities and counties have begun to enact laws that restrict subprime loan origination activities in those cities and counties. The laws and regulations of each of these jurisdictions are different, complex and, in some cases, in direct conflict with each other. As our operations continue to grow, it may be more difficult to comprehensively identify, to accurately interpret and to properly program our technology systems and effectively train our personnel with respect to all of these laws and regulations, thereby potentially increasing our exposure to the risks of noncompliance with these laws and regulations.

Our failure to comply with these laws can lead to:

- ∅ civil and criminal liability;
- ∅ loss of licensure;
- ∅ damage to our reputation in the industry;
- ∅ inability to sell or securitize our loans;
- ∅ demands for indemnification or loan repurchases from purchasers of our loans;
- ∅ fines and penalties and litigation, including class action lawsuits; or
- ∅ administrative enforcement actions.

Any of these results could harm our results of operations, financial condition and business prospects.

**If warehouse lenders and securitization underwriters face exposure stemming from legal violations committed by the companies to whom they provide financing or underwriting services, this could increase our borrowing costs and harm the market for whole loans and mortgage-backed securities.**

In June 2003, a California jury found a warehouse lender and securitization underwriter liable in part for fraud on consumers committed by a lender to whom it provided financing and underwriting services. The jury found that the investment bank was aware of the fraud and substantially assisted the lender in perpetrating the fraud by providing financing and underwriting services that allowed the lender to continue to operate, and held the bank liable for 10% of the plaintiff's damages. This is the first case we know of in which an investment bank was held partly responsible for violations committed by the bank's mortgage lender customer. If other courts or regulators adopt this theory, investment banks may face increased litigation as they are named as defendants in lawsuits and regulatory actions against the mortgage companies with which they do business. Some investment banks may exit the business, charge more for warehouse lending or reduce the prices they pay for

whole loans in order to build in the costs of this potential litigation. This could, in turn, harm our results of operations, financial condition and business prospects.

**If lenders are prohibited from originating loans in the State of Illinois with fees in excess of 3% where the interest rate exceeds 8%, this could force us to curtail operations in Illinois.**

In March 2004, an Illinois Court of Appeals found that the Illinois Interest Act, which caps fees at 3% for loans with an interest rate in excess of 8%, is not preempted by federal law. This ruling contradicts the view of the Federal Circuit Courts of Appeal, most state courts, the OTS and the Illinois Office of the Attorney General. If this ruling is not overturned, we may reduce operations in Illinois since it will reduce the return we and our investors can expect on higher risk loans. Moreover, as a result of this ruling,

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plaintiffs are filing actions against lenders, including us, seeking various forms of relief as a result of any fees received in the past which exceeded the applicable thresholds. Any such actions, if decided against us, could harm our results of operations, financial condition and business prospects.

**High delinquencies or losses on the mortgage loans in our securitizations may decrease our cash flows or impair our ability to sell or securitize loans in the future.**

Loans we make to lower credit grade borrowers, including credit-impaired borrowers, entail a higher risk of delinquency and higher losses than loans we make to borrowers with better credit. Virtually all of our loans are made to borrowers who do not qualify for loans from conventional mortgage lenders. No assurance can be given that our underwriting criteria or methods will afford adequate protection against the higher risks associated with loans made to lower credit grade borrowers. We continue to be subject to risks of default and foreclosure following the sale of loans through securitization. To the extent such losses are greater than expected, the cash flows we receive through residual interests and from our securitizations structured as financings would be reduced. Increased delinquencies or losses may also reduce our ability to sell or securitize loans in the future. Any such reduction in our cash flows or impairment in our performance could harm our results of operations, financial condition and business prospects.

**The loss of our exemption under the Investment Company Act would harm us and the market price of our shares of common stock and our ability to make distributions to our stockholders.**

New Century Financial is not currently regulated as an investment company under the Investment Company Act of 1940, as amended, or the Investment Company Act, and we intend to operate so as to not become regulated as an investment company under the Investment Company Act. For example, we intend to qualify for an exemption under the Investment Company Act that is available to companies that are primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. Specifically, we intend to invest at least 55% of our assets in mortgage loans or mortgage-related assets securities that represent the entire ownership in a pool of mortgage loans and at least an additional 25% of our assets in mortgages, mortgage-related assets securities, securities of REITs and other real estate-related assets. As of June 30, 2004, 62% of our assets consisted of mortgage loans or mortgage-related assets that represent the entire ownership in a pool of mortgage loans and another 34% of our assets were invested in mortgages, mortgage-related assets, securities of REITs and other real estate-related assets.

If we fail to qualify for that exemption, we may be required to restructure our activities. For example, if the market value of our investments in equity securities were to increase by an amount that caused less than 55% of our assets to be invested in mortgage loans or mortgage-related assets that represent the entire ownership in a pool of mortgage loans, we might have to sell equity securities in order to qualify for an exemption under the Investment Company Act. In the event we must restructure our activities, our results of operations, financial condition and business prospects could be harmed.

**Our inability to realize cash proceeds from loan sales and securitizations in excess of the loan acquisition cost could harm our financial position.**

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The net cash proceeds received from loan sales consist of the premiums we receive on sales of loans in excess of the outstanding principal balance, plus the cash proceeds we receive from securitizations structured as sales, minus the discounts on loans that we have to sell for less than the outstanding

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principal balance. If we are unable to originate loans at a cost lower than the cash proceeds realized from loan sales, our results of operations, financial condition and business prospects could be harmed.

#### **Our credit facilities are subject to margin calls based on the lender's opinion of the value of our loan collateral. An unanticipated large margin call could harm our liquidity.**

The amount of financing we receive under our credit facilities depends in large part on the lender's valuation of the mortgage loans that secure the financings. Each such facility provides the lender the right, under certain circumstances, to reevaluate the loan collateral that secures our outstanding borrowings at any time. In the event the lender determines that the value of the loan collateral has decreased, it has the right to initiate a margin call. A margin call would require us to provide the lender with additional collateral or to repay a portion of the outstanding borrowings. Any such margin call could harm our liquidity, results of operations, financial condition and business prospects.

#### **We face intense competition that could harm our market share and our revenues.**

We face intense competition from finance and mortgage banking companies and from Internet-based lending companies. In addition, certain government-sponsored entities, such as Fannie Mae and Freddie Mac, are also expanding their participation in the subprime mortgage industry. These government-sponsored entities have a size and cost-of-funds advantage that allows them to purchase loans with lower rates or fees than we are willing to offer. While the government-sponsored entities presently do not have the legal authority to originate mortgage loans, including subprime loans, they do have the authority to buy loans. A material expansion of their involvement in the market to purchase subprime loans could change the dynamics of the industry by virtue of their sheer size, pricing power and the inherent advantages of a government charter. In addition, if as a result of their purchasing practices, these government-sponsored entities experience significantly higher-than-expected losses, such experience could harm the overall investor perception of the subprime mortgage industry.

Certain large finance companies and conforming mortgage originators also originate subprime mortgage loans to customers similar to the borrowers we serve. Competitors with lower costs of capital have a competitive advantage over us. In addition, establishing a wholesale lending operation such as ours requires a relatively small commitment of capital and human resources. This low barrier to entry permits new competitors to enter our markets quickly and compete with our wholesale lending business. Several new wholesale originators have been formed in recent years and have recruited former senior managers from our Wholesale Division. If these competitors are able to attract some of our key employees and disrupt our broker relationships, it could harm our results of operations, financial condition and business prospects.

Some thrifts, national banks and their operating subsidiaries are also expanding their subprime mortgage lending activities. By virtue of their charters, these institutions are exempt from complying with many of the state and local laws that affect our operations. For example, they are permitted to offer loans with prepayment charges in many jurisdictions where we cannot. If more of these federally chartered institutions are able to use their preemptive ability to provide more competitive pricing and terms than we can offer, it could harm our results of operations, financial condition and business prospects. We may also be forced to expand our operations at a pace that does not allow us to attract a sufficient number of employees with the capability to ensure we are in compliance with the numerous complex regulations applicable to our business as well as to enable us to provide high quality customer service and this could harm our results of operations, financial condition and business prospects.





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In addition, to the extent we must purchase mortgage loans or mortgage-related assets from third parties, we must compete with other REITs, investment banking firms, savings and loan associations, banks, insurance companies, other lenders and other entities that purchase mortgage loans or mortgage-backed securities, many of which have greater financial resources than we do. As a result, we may not be able to acquire sufficient mortgage-related assets with favorable yields over our borrowing costs, which could harm our results of operations, financial condition and business prospects.

The intense competition in the subprime mortgage industry has also led to rapid technological developments, evolving industry standards and frequent releases of new products and enhancements. As mortgage products are offered more widely through alternative distribution channels, such as the Internet, we may be required to make significant changes to our current wholesale and retail structures and information systems to compete effectively. Our inability to continue enhancing our current Internet capabilities, or to adapt to other technological changes in the industry, could harm our results of operations, financial condition and business prospects.

**Our hedging strategies may not be successful in mitigating our risks associated with interest rates.**

We use various derivative financial instruments to provide a level of protection against interest rate risks, but no hedging strategy can protect us completely. When rates change, we expect to record a gain or loss on derivatives, which would be offset by an inverse change in the value of loans or residual interests. Additionally, from time to time, we may enter into hedging transactions in connection with our holdings of mortgage-backed securities and government securities with respect to one or more of our assets or liabilities. Our hedging activities may include entering into interest rate swaps, caps and floors, options to purchase these items, and futures and forward contracts. Currently, we intend to primarily use Euro Dollar Futures contracts and interest rate swap agreements to manage the interest rate risk of our portfolio of adjustable-rate mortgages; however, our actual hedging decisions will be determined in light of the facts and circumstances existing at the time and may differ from our currently anticipated hedging strategy.

We cannot assure you that our use of derivatives will offset the risks related to changes in interest rates. There have been periods, and it is likely that there will be periods in the future, during which we will incur losses after accounting for our derivative financial instruments. The derivative financial instruments we select may not have the effect of reducing our interest rate risk. In addition, the nature and timing of hedging transactions may influence the effectiveness of these strategies. Poorly designed strategies or improperly executed transactions could actually increase our risk and losses. In addition, hedging strategies involve transaction and other costs. We cannot assure you that our hedging strategy and the derivatives that we use will adequately offset the risk of interest rate volatility or that our hedging transactions will not result in losses, and such losses could harm our results of operations, financial condition and business prospects. See Management's discussion and analysis of financial condition and results of operations Quantitative and qualitative disclosures about market risk.

**Complying with REIT requirements may limit our ability to hedge interest rate risk effectively.**

The existing REIT provisions of the Internal Revenue Code substantially limit our ability to hedge mortgage-backed securities and government securities and related borrowings. Under these provisions, our aggregate gross income from qualified hedges (which generally include certain financial instruments used to hedge indebtedness incurred or to be incurred to acquire or carry real estate assets), together



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with any other income from certain non-qualifying sources, is limited to not more than 25% of our gross income. In addition, we must limit our aggregate gross income from non-qualified hedges, fees, and certain other non-qualifying sources to not more than 5% of our annual gross income. As a result, we might in the future have to limit our use of advantageous hedging techniques or implement those hedges through a taxable REIT subsidiary. This could increase the cost of our hedging activities or leave us exposed to greater risks associated with changes in interest rates than we would otherwise want to bear, which could harm our results of operations, financial condition and business prospects.

**A decline in the quality of servicing could lower the value of our residual interests and our ability to sell or securitize loans and could harm the cash flows from our on-balance sheet securitizations.**

In March 2001, we sold to Ocwen Federal Bank FSB the servicing rights on \$4.8 billion of our servicing portfolio, which consisted of 25 separate asset-backed securities. In August 2001, Ocwen began servicing all of our newly originated loans pending their sale or securitization. However, in February 2002, we announced the intent to re-establish our in-house loan servicing platform. By October 1, 2002, we began servicing loans on our in-house servicing platform and at June 30, 2004, loans serviced on our platform totaled \$20.9 billion. Ocwen is expected to continue to service the mortgage loans underlying our residual interests. Poor servicing and collections by third-party servicers could harm the value of our residual interests and our ability to sell or securitize loans, which could harm our results of operations, financial condition and business prospects. Likewise, poor servicing by our own servicing operation could harm the cash flows from our on-balance sheet securitizations, could hamper our ability to sell or securitize loans and could harm our results of operations, financial condition and business prospects.

**The complex federal, state and municipal laws governing loan servicing activities could increase our exposure to the risk of noncompliance.**

We service loans originated on a nationwide basis. Therefore, we must comply with the laws and regulations, as well as judicial and administrative decisions, of all relevant jurisdictions pertaining to loan servicing, as well as an extensive body of federal laws and regulations. The volume of new or modified laws and regulations has increased in recent years and, in addition, some individual municipalities have begun to enact laws that restrict loan servicing activities. The laws and regulations of each of these jurisdictions are different, complex and, in some cases, in direct conflict with each other. As our servicing operations continue to grow, it may be more difficult to comprehensively identify, to accurately interpret and to properly program our technology systems and effectively train our personnel with respect to all of these laws and regulations, thereby potentially increasing our exposure to the risks of noncompliance with the laws and regulations pertaining to loan servicing. Our failure to comply with these laws could lead to, among other things: (i) civil and criminal liability, including potential monetary penalties; (ii) legal defenses delaying or otherwise harming the servicer's ability to enforce loans, or giving the borrower the right to rescind or cancel the loan transactions; (iii) class action lawsuits; and (iv) administrative enforcement actions. This could harm our results of operations, financial condition and business prospects.

**We are subject to losses due to fraudulent and negligent acts on the part of loan applicants, mortgage brokers, other vendors and our employees.**

When we originate mortgage loans, we rely heavily upon information supplied by third parties, including the information contained in the loan application, property appraisal, title information and employment and income documentation. If any of this information is intentionally or negligently misrepresented and



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such misrepresentation is not detected prior to loan funding, the value of the loan may be significantly lower than expected. Whether a misrepresentation is made by the loan applicant, the mortgage broker, another third party or one of our employees, we generally bear the risk of loss associated with the misrepresentation. A loan subject to a material misrepresentation is typically unsaleable or subject to repurchase if it is sold prior to detection of the misrepresentation, and the persons and entities involved are often difficult to locate and it is often difficult to collect any monetary losses that we have suffered from them.

We have controls and processes designed to help us identify misrepresented information in our loan origination operations. We cannot assure you, however, that we have detected or will detect all misrepresented information in our loan originations.

**We may be subject to fines or other penalties based upon the conduct of our independent brokers.**

The mortgage brokers from which we obtain loans have parallel and separate legal obligations to which they are subject. While these laws may not explicitly hold the originating lenders responsible for the legal violations of mortgage brokers, increasingly federal and state agencies have sought to impose such liability on parties that take assignments of such loans. Recently, for example, the United States Federal Trade Commission, or FTC, entered into a settlement agreement with a mortgage lender where the FTC characterized a broker that had placed all of its loan production with a single lender as the agent of the lender. The FTC imposed a fine on the lender in part because, as principal, the lender was legally responsible for the mortgage broker's unfair and deceptive acts and practices. The United States Justice Department in the past has sought to hold a subprime mortgage lender responsible for the pricing practices of its mortgage brokers, alleging that the mortgage lender was directly responsible for the total fees and charges paid by the borrower under the Fair Housing Act even if the lender neither dictated what the mortgage broker could charge nor kept the money for its own account. Accordingly, we may be subject to fines or other penalties based upon the conduct of our independent mortgage brokers.

**Changes in the volume and cost of loans originated by our Wholesale Division may decrease our loan production and decrease our earnings.**

We depend primarily on independent mortgage brokers and, to a lesser extent, on correspondent lenders for the origination and purchase of our wholesale mortgage loans, which constitute the majority of our loan production. These independent mortgage brokers have relationships with multiple lenders and are not obligated by contract or otherwise to do business with us. We compete with these lenders for the independent brokers' business on pricing, service, loan fees, costs and other factors. Competition from other lenders and purchasers of mortgage loans could negatively affect the volume and pricing of our wholesale loans, which could harm our results of operations, financial condition and business prospects.

**If many of our borrowers become subject to the Servicemembers Civil Relief Act of 2003, our cash flows from our residual securities and our securitizations structured as financings may be harmed.**

Under the Servicemembers Civil Relief Act, which in 2003 re-enacted the Soldiers and Sailors Civil Relief Act of 1940, a borrower who enters military service after the origination of the borrower's mortgage loan generally may not be charged interest above an annual rate of 6% during the period of the borrower's active duty status. The Act also applies to a borrower who was on reserve status and is called to active duty after

origination of the mortgage loan. A prolonged, significant military mobilization as

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part of the war on terrorism or the war in Iraq could increase the number of the borrowers in our securitized pools who are subject to the Act and thereby reduce the interest payments collected from those borrowers. To the extent the number of borrowers who are subject to the Act is significant, the cash flows we receive from loans underlying our on-balance sheet securitizations and from our residual interests would be reduced, which could cause us to reduce the carrying value of our residual interests and would decrease our earnings. In addition, the Act imposes limitations that would impair the ability of the servicer to foreclose on an affected mortgage loan during the borrower's period of active duty status, and, under certain circumstances, during an additional three month period thereafter. Any such reduction in our cash flows or impairment in our performance could harm our results of operations, financial condition and business prospects.

#### **The inability to attract and retain qualified employees could significantly harm our business.**

We depend on our wholesale account executives and retail loan officers to attract borrowers by, among other things, developing relationships with financial institutions, other mortgage companies and brokers, real estate agents, borrowers and others. We believe that these relationships lead to repeat and referral business. The market for skilled account executives and loan officers is highly competitive and historically has experienced a high rate of turnover. In addition, if a manager is no longer employed by us, there is an increased likelihood that other members of his or her team will leave our employ as well. Competition for qualified account executives and loan officers may lead to increased hiring and retention costs. If we are unable to attract or retain a sufficient number of skilled account executives at manageable costs, we will be unable to continue to originate quality mortgage loans that we are able to sell for a profit, which would harm our results of operations, financial condition and business prospects.

#### **An interruption in or breach of our information systems may result in lost business.**

We rely heavily upon communications and information systems to conduct our business. Any failure or interruption or breach in security of our information systems or the third-party information systems on which we rely could cause underwriting or other delays and could result in fewer loan applications being received, slower processing of applications and reduced efficiency in loan servicing. We are required to comply with significant federal and state regulations with respect to the handling of customer information, and a failure, interruption or breach of our information systems could result in regulatory action and litigation against us. We cannot assure you that such failures or interruptions will not occur or if they do occur that they will be adequately addressed by us or the third parties on which we rely. The occurrence of any failures or interruptions could harm our results of operations, financial condition and business prospects.

#### **The success and growth of our business will depend upon our ability to adapt to and implement technological changes.**

Our mortgage loan origination business is currently dependent upon our ability to effectively interface with our brokers, borrowers and other third parties and to efficiently process loan applications and closings. The origination process is becoming more dependent upon technological advancement, such as the ability to process applications over the Internet, accept electronic signatures and provide process status updates instantly and other customer-expected conveniences that are cost-efficient to our process. In addition, we are in the process of implementing a new loan origination system. Implementing and becoming proficient with the new loan origination system and other new technology will require significant financial and personnel resources. There is no guarantee that the implementation of our new





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loan origination system or other new technology will be successful. To the extent that we become reliant on any particular technology or technological solution, we may be harmed to the extent that such technology or technological solution (i) becomes non-compliant with existing industry standards, (ii) fails to meet or exceed the capabilities of our competitors' equivalent technologies or technological solutions, (iii) becomes increasingly expensive to service, retain and update, or (iv) becomes subject to third-party claims of copyright or patent infringement. Any failure to acquire technologies or technological solutions when necessary could limit our ability to remain competitive in our industry and could also limit our ability to increase the cost-efficiencies of our operating model, which would harm our results of operations, financial condition and business prospects.

**We may be required to repurchase mortgage loans or indemnify investors if we breach representations and warranties, which could harm our earnings.**

When we sell loans, we are required to make customary representations and warranties about such loans to the loan purchaser. Our whole loan sale agreements require us to repurchase or substitute loans in the event we breach a representation or warranty given to the loan purchaser or make a misrepresentation during the mortgage loan origination process. In addition, we may be required to repurchase loans as a result of borrower fraud or in the event of early payment default on a mortgage loan. Likewise, we are required to repurchase or substitute loans if we breach a representation or warranty in connection with our securitizations. The remedies available to a purchaser of mortgage loans are generally broader than those available to us against the originating broker or correspondent. Further, if a purchaser enforces its remedies against us, we may not be able to enforce the remedies we have against the sellers. The repurchased loans typically can only be financed at a steep discount to their repurchase price, if at all. They are also typically sold at a significant discount to the unpaid principal balance. Significant repurchase activity could harm our cash flow, results of operations, financial condition and business prospects.

**We are exposed to risk of environmental liabilities with respect to properties to which we take title.**

In the course of our business, we may foreclose and take title to residential properties and could be subject to environmental liabilities with respect to these properties. We may be held liable to a governmental entity or to third parties for property damage, personal injury, investigation, and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, as the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. If we ever become subject to significant environmental liabilities, our cash flow, results of operations, financial condition and business prospects could be harmed.

**If we do not manage our growth effectively, our financial performance could be harmed.**

In recent years, we have experienced rapid growth that has placed, and will continue to place, certain pressures on our management, administrative, operational and financial infrastructure. As of December 31, 2000, we had approximately 1,511 employees and by June 30, 2004, we had approximately 4,600 employees. Many of these employees have a limited understanding of our systems and controls. The increase in the size of our operations may make it more difficult for us to ensure that we originate quality



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loans and that we service them effectively. We will need to attract and hire additional sales and management personnel in an intensely competitive hiring environment in order to preserve and increase our market share. At the same time, we will need to continue to upgrade and expand our financial, operational and managerial systems and controls.

#### **Various factors may cause the market price of our common stock to become volatile, which could harm our ability to access the capital markets in the future.**

The market price of our common stock may experience fluctuations that are unrelated to our operating performance. In particular, the market price of our common stock may be affected by general market price movements as well as developments specifically related to the consumer finance industry and the financial services sector. These could include, among other things, interest rate movements, quarterly variations or changes in financial estimates by securities analysts, or a significant reduction in the price of the stock of another participant in the consumer finance industry. This volatility may make it difficult for us to access the capital markets through additional secondary offerings of our common stock, regardless of our financial performance, and such difficulty may preclude us from being able to take advantage of certain business opportunities or meet our obligations, which could, in turn, harm our results of operations, financial condition and business prospects.

#### **We may change our policies in ways that harm our financial condition or results of operations.**

Our investment and financing policies and our policies with respect to other activities, including our growth, debt capitalization, distributions, REIT status and operating policies are determined by our board of directors. Our board of directors may change these policies at any time without a vote of our stockholders. A change in these policies might harm our financial condition, results of operations or business prospects.

#### **Compliance with the Sarbanes-Oxley Act of 2002 and proposed and recently enacted changes in securities laws and regulations are likely to increase our costs.**

The Sarbanes-Oxley Act of 2002 and rules and regulations promulgated by the Securities and Exchange Commission and the NYSE have increased the scope, complexity and cost of corporate governance, reporting and disclosure practices for public companies, including ourselves. These rules and regulations could also make it more difficult for us to attract and retain qualified executive officers and members of our board of directors, particularly to serve on our audit committee.

### **RISKS RELATED TO OUR COMMON STOCK**

**There has been no prior public market for our common stock.**

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Before this offering, there has been no public market for New Century REIT common stock. Among the factors considered in determining the offering price of our common stock, in addition to prevailing market conditions, were the historical performance of New Century Financial, estimates regarding our business potential and earnings prospects, an assessment of our management and the consideration of the above factors in relation to market valuation of companies in related businesses. The public offering price of New Century REIT common stock may bear no relationship to the price at which its common stock will trade upon completion of this offering. The stock market may experience price and volume fluctuations and you may not be able to sell your shares at or above the public offering price.

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**We cannot be sure that a public trading market for New Century REIT common stock will develop or be maintained.**

Even though our common stock has been approved for listing on the NYSE, subject to official notice of issuance, there can be no assurance that an established and liquid trading market for our common stock will develop or that it will continue if it does develop. The representatives of the underwriters have advised us that they intend to make a market in our common stock. However, neither the representatives of the underwriters nor any other market maker is obligated to make a market in such shares, and any such market making may be discontinued at any time in the sole discretion of the party making such market.

**Our stock price and trading volume may be volatile, which could result in substantial losses for our stockholders.**

Even if an active trading market develops for our common stock after this offering, the market price of our common stock may be highly volatile and be subject to wide fluctuations. In addition, the trading volume in our common stock may fluctuate and cause significant price variations to occur. Some of the factors that could negatively affect our share price or result in fluctuations in the price or trading volume of our common stock include:

- ∅ general market and economic conditions;
- ∅ actual or anticipated changes in our future financial performance;
- ∅ changes in market interest rates;
- ∅ competitive developments, including announcements by us or our competitors of new products or services or significant contracts, acquisitions, strategic partnerships or capital commitments;
- ∅ the operations and stock performance of our competitors;
- ∅ developments in the mortgage lending industry or the financial services sector generally;
- ∅ the impact of new state or federal legislation or court decisions restricting the activities of lenders or suppliers of credit in our market;
- ∅ fluctuations in our quarterly operating results;
- ∅ changes in financial estimates by securities analysts;

Ø additions or departures of senior management and key personnel; and

Ø actions by institutional stockholders.

If the market price of our common stock declines significantly, you may be unable to resell your common stock at or above the public offering price. We cannot assure you that the market price of our common stock will not fluctuate or decline significantly, including a decline below the initial public offering price, in the future. In addition, the stock market in general can experience considerable price and volume fluctuations.

**We have not established a minimum distribution level and we may not have the ability to make distributions to you in the future.**

We intend to make quarterly distributions following the end of the first full fiscal quarter after completion of this offering and to make distributions to our stockholders of all or substantially all of our

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REIT taxable income, excluding net capital gains, in each year. We have not established a minimum distribution level and we may not be able to make distributions. In addition, some of our distributions may include a return of capital. All distributions will be made at the discretion of our board of directors and will depend on our earnings, our financial condition, maintenance of our REIT status and other factors as our board of directors may deem relevant from time to time. We cannot predict our ability to make distributions to you in the future.

**Future sales of shares of our common stock, including shares of common stock by our insiders, may depress the price of our common stock.**

Any sales of a substantial number of shares of our common stock, or the perception that those sales might occur, may cause the market price of our common stock to decline. Our directors and some of our officers have agreed with the underwriters not to sell the common stock they hold earlier than 90 days after the date of this prospectus; provided, however, that Messrs. Cole, Morrice and Gotschall are each permitted to sell or transfer up to 200,000 shares of our common stock consistent with past practices for tax planning purposes. We also expect that we will enter into a lock-up agreement with an affiliate of Friedman Billings relating to the 586,338 shares of our common stock that such affiliate of Friedman Billings may purchase in the concurrent private placement. We expect that these shares will be subject to a six month lock-up period. We are unable to predict whether significant numbers of shares will be sold in the open market in anticipation of or following a sale by insiders.

Based on the number of shares of New Century Financial common stock outstanding on August 31, 2004, upon completion of this offering, we will have approximately 47,567,884 shares of common stock outstanding, and approximately 50,179,222 shares outstanding if we issue shares of our common stock upon exercise of the underwriters' option to purchase additional shares and issue 586,338 shares of our common stock to the affiliate of Friedman Billings in the concurrent private placement. All shares of our common stock that will be outstanding following the merger, this offering and the concurrent private placement will be freely transferable, except for the restrictions on ownership contained in our charter, restrictions on transfers of shares held by our directors and some of our officers which are subject to the lock-up agreements described above, restrictions on transfers of the 586,338 shares of our common stock that may be purchased by the affiliate of Friedman Billings in the concurrent private placement, which we expect will be subject to a lock-up agreement as described above, and restrictions on resales by our affiliates pursuant to Rule 145(d) of the Securities Act. Beginning 91 days following the date of this prospectus, approximately 4,548,595 shares of our common stock outstanding on August 31, 2004 will no longer be subject to lock-up restrictions and will be tradable subject to the provisions of Rule 145. In addition, as of August 31, 2004, there were outstanding options to purchase 5,342,736 shares of New Century Financial's common stock. New Century Financial's 3.50% convertible senior notes due 2008 are convertible into 6,034,686 shares of our common stock as of August 31, 2004, subject to adjustments under the terms of the convertible notes. In addition, New Century Financial has a warrant outstanding that is exercisable for up to 6,034,668 shares of our common stock as of August 31, 2004, subject to anti-dilution and other customary adjustments. This warrant may be settled in cash, in shares or in a combination of cash or shares, at our option, and is exercisable upon maturity of the convertible notes described above. We have granted registration rights with respect to approximately 3,060,492 shares of our common stock and all of the shares underlying the convertible notes. We expect we will enter into a registration rights agreement with the affiliate of Friedman Billings in connection with the concurrent private placement and will agree to register the resale of the shares of our common stock that the affiliate purchases in the concurrent private placement. In the future, we may grant additional options or grant additional registration rights with respect to our common stock.

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**Our board of directors may authorize the issuance of additional shares that may cause dilution and may depress the price of our common stock.**

Our charter permits our board of directors, without your approval, to:

- ∅ authorize the issuance of additional common or preferred stock in connection with future equity offerings, acquisitions of securities or other assets of companies; and
- ∅ classify or reclassify any unissued common stock or preferred stock and to set the preferences, rights and other terms of the classified or reclassified shares, including the issuance of shares of preferred stock that have preference rights over the common stock with respect to dividends, liquidation, voting and other matters or shares of common stock that have preference rights over your common stock with respect to voting.

The issuance of additional shares of our common stock could be substantially dilutive to your shares and may depress the price of our common stock.

**Future offerings of debt securities, which would be senior to our common stock in liquidation, or equity securities, which would dilute our existing stockholders' interests and may be senior to our common stock for the purposes of distributions, may harm the market price of our common stock.**

In the future, we will seek to access the capital markets from time to time by making additional offerings of debt and/or equity securities, including commercial paper, medium-term notes, senior or subordinated notes, preferred stock or common stock. We will not be precluded by the terms of our charter documents from issuing additional indebtedness. Accordingly, we could become more highly leveraged, resulting in an increase in debt service that could harm our ability to make expected distributions to stockholders and in an increased risk of default on our obligations. If we were to liquidate, holders of our debt and shares of preferred stock and lenders with respect to other borrowings will receive a distribution of our available assets before the holders of our common stock. Additional equity offerings by us may dilute your interest in us or reduce the market price of your shares of our common stock, or both. Our preferred stock, if issued, could have a preference on distribution payments that could limit our ability to make a distribution to you. Because our decision to issue securities in any future offering will depend on market conditions and other factors beyond our control, we cannot predict or estimate the amount, timing or nature of our future offerings. Further, market conditions could require us to accept less favorable terms for the issuance of our securities in the future. Thus, you will bear the risk of our future offerings reducing the market price of your shares of our common stock and diluting your interest in us.

**If you purchase shares in this offering, you will experience immediate and substantial dilution.**

We expect the offering price of our common stock to be higher than the book value per share of our common stock immediately following this offering, the concurrent private placement and our completion of the merger. Accordingly, if you purchase common stock in this offering, you will experience immediate dilution of approximately \$30.33 in net tangible book value per share following our completion of the merger. This means that investors who purchase shares will likely pay a price per share that exceeds the net book value of our tangible assets after subtracting



our liabilities following our completion of the merger.

Moreover, to the extent that we issue options or warrants to purchase our common stock in the future and those options or warrants are exercised, you may experience further dilution.

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**TAX RISKS RELATED TO OUR STATUS AS A REIT**

**Your investment has various federal income tax risks.**

Although the provisions of the Internal Revenue Code relevant to your investment are generally described in Material U.S. federal income tax consequences, we strongly urge you to consult with your own tax advisor concerning the effects of federal, state and local income tax law on an investment in our common stock and on your individual tax situation.

**We may be unable to comply with the requirements applicable to REITs or compliance with such requirements could harm our financial condition.**

We intend to qualify as a REIT under the Internal Revenue Code, which will afford us significant tax advantages. The requirements for this qualification, however, are highly technical and complex and our management has limited experience in operating a REIT. Even a technical or inadvertent mistake could jeopardize our REIT status. The determination that we qualify as a REIT requires an analysis of various factual matters and circumstances that may not be totally within our control. For example, to qualify as a REIT, at least 75% of our gross income must come from real estate sources and 95% of our gross income must come from real estate sources and certain other sources that are itemized in the REIT tax laws, mainly interest and dividends. We are subject to various limitations on our ownership of securities, including a limitation that the value of our investment in taxable REIT subsidiaries, including New Century Financial and its subsidiaries, cannot exceed 20% of our total assets. In addition, at the end of each calendar quarter, at least 75% of our assets must be qualifying real estate assets, government securities and cash and cash items. The need to comply with these asset ownership requirements may cause us to acquire other assets that are qualifying real estate assets for purposes of the REIT requirements (for example, interests in other mortgage loan portfolios or mortgage-related assets) but are not part of our overall business strategy and might not otherwise be the best investment alternative for us. Moreover, we may be unable to acquire sufficient qualifying REIT assets, due to our inability to obtain adequate financing or otherwise, in which case we may fail to qualify as a REIT.

To qualify as a REIT, we must distribute to our stockholders with respect to each year at least 90% of our REIT taxable income (determined without regard to the dividends paid deduction and by excluding any net capital gain). After-tax earnings generated by our taxable REIT subsidiaries and not distributed to us are not subject to these distribution requirements and may be retained by such subsidiaries to provide for future growth, subject to the limitations imposed by REIT tax rules. To the extent that we satisfy this distribution requirement, but distribute less than 100% of our taxable income, we will be subject to federal corporate income tax on our undistributed taxable income. In addition, we will be subject to a 4% nondeductible excise tax if the actual amount that we pay out to our stockholders in a calendar year is less than a minimum amount specified under federal tax laws. We could be required to seek to borrow funds on a short-term basis even if conditions are not favorable for borrowing, or to sell loans from our portfolio potentially at disadvantageous prices, to meet the REIT distribution requirements and to avoid corporate income tax and the 4% nondeductible excise tax. These alternatives could harm our financial condition and could reduce amounts available to originate mortgage loans.

If we fail to qualify or remain qualified as a REIT, our distributions will not be deductible by us, and we will be subject to federal income tax on our taxable income. This would substantially reduce our earnings, our cash available to pay distributions and your yield on your investment in our stock. We would not be required to make any distributions to stockholders. The resulting tax liability, in the event of our failure to qualify as a REIT, might cause us to borrow funds, liquidate some of our investments or take other steps that could negatively affect our operating results.

Moreover, if our REIT status is

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terminated because of our failure to meet a technical REIT requirement or if we voluntarily revoke our election, we generally would be disqualified from electing treatment as a REIT for the four taxable years following the year in which REIT status is lost.

**We may not qualify as a REIT if the value of our investment in our taxable REIT subsidiaries exceeds 20% of the value of our total assets at the close of any calendar quarter.**

To qualify as a REIT, not more than 20% of the value of our total assets may be represented by the securities of one or more taxable REIT subsidiaries at the close of any calendar quarter, subject to a 30-day cure period following the close of the quarter (except that no cure period is available during the initial qualification as a REIT). See Material U.S. federal income tax consequences Asset tests. Our taxable REIT subsidiaries, including New Century Financial and its subsidiaries, conduct a substantial portion of our business activities, including a majority of our loan origination and servicing activities. Under our current business plan, we expect to accumulate a significant amount of earnings in our taxable REIT subsidiaries. We will monitor the value of our investment in New Century Financial and our other taxable REIT subsidiaries in relation to our other assets to comply with the 20% asset test. There cannot be complete assurance that we will be successful in that effort. In certain cases, we may need to borrow from third parties to acquire additional qualifying REIT assets or increase the amount and frequency of dividends from our taxable REIT subsidiaries in order to comply with the 20% asset test. Moreover, there can be no assurance that the Internal Revenue Service will not disagree with those determinations. If the Internal Revenue Service determines that the value of our investment in New Century Financial and other taxable REIT subsidiaries was more than 20% of the value of our total assets at the close of any calendar quarter, we could lose our REIT status.

**We may incur excess inclusion income that would increase the tax liability of our stockholders.**

In general, dividend income that a tax-exempt entity receives from us should not constitute unrelated business taxable income as defined in Section 512 of the Internal Revenue Code. If we realize excess inclusion income and allocate it to stockholders, however, then this income would be fully taxable as unrelated business taxable income under Section 512 of the Internal Revenue Code. If the stockholder is foreign, it would generally be subject to U.S. federal income tax withholding on this income without reduction pursuant to any otherwise applicable income-tax treaty. U.S. stockholders would not be able to offset such income with net operating losses.

Excess inclusion income could result if we held a residual interest in a real estate mortgage investment conduit, or REMIC. Excess inclusion income also may be generated if we were to issue debt obligations with two or more maturities and the terms of the payments on these obligations bore a relationship to the payments that we received on our mortgage-backed securities securing those debt obligations. We may enter into various repurchase agreements that have differing maturity dates and afford the lender the right to sell any pledged mortgage securities if we default on our obligations. In addition, we may engage in non-REMIC collateralized mortgage obligation, or CMO, securitizations. The Internal Revenue Service may determine that these borrowings give rise to excess inclusion income that should be allocated among our stockholders. Finally, we may invest in equity securities of other REITs and it is possible that we might receive excess inclusion income from those investments.

**Our use of taxable REIT subsidiaries may affect the price of our common stock relative to the stock price of other REITs.**

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Following our election to be taxed as a REIT, we will conduct a substantial portion of our mortgage loan origination and servicing activities through one or more taxable REIT subsidiaries and possibly one or

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more qualified REIT subsidiaries. Taxable REIT subsidiaries are corporations subject to corporate-level tax. This REIT/taxable REIT subsidiary structure may cause the market to place a lower value on our common stock than the stock of other publicly-traded REITs, which may not use taxable REIT subsidiaries as extensively as we plan to following our election to be taxed as a REIT.

**Even if we qualify as a REIT, the income earned by our taxable REIT subsidiaries will be subject to federal income tax and we could be subject to an excise tax on non-arm s-length transactions with our taxable REIT subsidiaries.**

Our taxable REIT subsidiaries, including New Century Financial and its subsidiaries, expect to earn income from activities that are prohibited for REITs, and will owe income taxes on the taxable income from these activities. For example, we expect that New Century Financial and its subsidiaries will earn income from our loan origination and sales activities, as well as from other origination and servicing functions, which would generally not be qualifying income for purposes of the gross income tests applicable to REITs or might otherwise be subject to adverse tax liability if the income were generated by a REIT. New Century Financial and its subsidiaries will be taxable as C corporations and will be subject to federal, state and local income tax at the applicable corporate rates on their taxable income, notwithstanding our qualification as a REIT.

In the event that any transactions between us and New Century Financial and its subsidiaries are not conducted on an arm s-length basis, we could be subject to a 100% excise tax on certain amounts from such transactions. We believe that all such transactions will be conducted on an arm s-length basis, but there can be no assurance that the Internal Revenue Service will not successfully contest the arm s-length nature of such transactions or that we will otherwise be able to avoid application of the 100% excise tax. Any such tax could affect our overall profitability and the amounts of distributions to our stockholders.

We may, at some point in the future, borrow funds from one or more of our corporate subsidiaries. Although any such intercompany borrowings will be structured so as to constitute indebtedness for all tax purposes, no assurance can be given that the Internal Revenue Service will not challenge such arrangements, in which case the borrowing may be recharacterized as a dividend distribution to us by our subsidiary. Any such recharacterization may cause us to fail one or more of the REIT requirements.

**Complying with REIT requirements might cause us to forego otherwise attractive opportunities, including certain acquisitions.**

In order to qualify as a REIT for U.S. federal income tax purposes, we must satisfy tests concerning, among other things, our sources of income, the nature and diversification of our assets, the amounts we distribute to our stockholders and the ownership of our stock. We may also be required to make distributions to our stockholders at disadvantageous times or when we do not have funds readily available for distribution. Thus, compliance with REIT requirements may cause us to forego opportunities, including certain acquisitions, we would otherwise pursue.

**The tax imposed on REITs engaging in prohibited transactions will limit our ability to engage in transactions, including certain methods of securitizing loans, that would be treated as sales for federal income tax purposes.**

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A REIT's net income from prohibited transactions is subject to a 100% tax. In general, prohibited transactions are sales or other dispositions of property, other than foreclosure property but including any mortgage loans held in inventory primarily for sale to customers in the ordinary course of business. We

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might be subject to this tax if we were to sell a loan or securitize the loans in a manner that was treated as a sale of such inventory for federal income tax purposes. Therefore, in order to avoid the prohibited transactions tax, we may choose not to engage in certain sales of loans other than through our taxable REIT subsidiaries and may limit the structures we utilize for our securitization transactions even though such sales or structures might otherwise be beneficial for us. In addition, this prohibition may limit our ability to restructure our portfolio of mortgage loans from time to time even if we believe it would be in our best interest to do so. However, the sales of loans we expect to make from New Century Financial and its subsidiaries following the merger will not be subject to this prohibited transaction tax since New Century Financial and its subsidiaries will be taxable REIT subsidiaries.

**Misplaced reliance on legal opinions or statements by issuers of mortgage-backed securities and government securities could result in a failure to comply with REIT gross income or assets tests.**

When purchasing mortgage-backed securities and government securities, we may rely on opinions of counsel for the issuer or sponsor of such securities, or statements made in related offering documents, for purposes of determining whether and to what extent those securities constitute REIT real estate assets for purposes of the REIT asset tests and produce income that qualifies under the REIT gross income tests. The inaccuracy of any such opinions or statements may harm our REIT qualification and result in significant corporate level tax.

**We may not qualify as a REIT if we fail to distribute as of the end of calendar year 2004 any undistributed earnings and profits that are attributable to New Century Credit.**

To qualify as a REIT, we cannot have as of the end of any taxable year any undistributed earnings and profits that are attributable to a non-REIT C corporation, or C corporation E&P. As part of the formation transactions, we expect to acquire all of the capital stock of New Century Credit, which is currently an indirect wholly-owned subsidiary of New Century Financial. After the acquisition, New Century Credit will become a qualified REIT subsidiary and we may succeed to any of New Century Credit's C corporation E&P. If we succeed to that C corporation E&P, we will be required to distribute any such C corporation E&P as of the close of our first taxable year as a REIT. You generally would be subject to tax on the distribution of New Century Credit's C corporation E&P at ordinary income tax rates. It appears that stockholders who are taxed as U.S. individuals would generally be taxed at a maximum rate of 35% on that distribution, rather than the 15% rate applicable to certain corporate dividends, even though that distribution would be attributable to non-REIT C corporation E&P. Legislation introduced in Congress would treat our distribution of C corporation E&P as eligible for the 15% rate applicable to certain corporate dividends. We can provide no assurance that such legislation will be enacted into law.

A national accounting firm will prepare an estimate of New Century Credit's C corporation E&P, which we will use to determine the amount of the special E&P distribution that we must make to purge New Century Credit's C corporation E&P, if any. However, the determination of C corporation E&P is extremely complex and the computations by our national accounting firm are not binding on the Internal Revenue Service. If the Internal Revenue Service were to successfully assert that we failed to distribute an amount at least equal to the inherited C corporation E&P of New Century Credit as of the close of our first taxable year as a REIT, we could fail to qualify as a REIT.

**We may be harmed by changes in tax laws applicable to REITs, or the reduced 15% tax rate on certain corporate dividends.**



Our business may be harmed by changes to the laws and regulations affecting us, including changes to securities laws and changes to the Internal Revenue Code applicable to the taxation of REITs. New

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legislation may be enacted into law or new interpretations, rulings or regulations could be adopted, any of which could harm us and our stockholders, potentially with retroactive effect.

Generally, dividends paid by REITs are not eligible for the 15% U.S. federal income tax rate on certain corporate dividends, with certain exceptions discussed under the caption **Material U.S. federal income tax consequences** **Taxation of U.S. holders of our common stock**. The more favorable treatment of regular corporate dividends could cause domestic non-corporate investors to consider stocks of other corporations that pay dividends as more attractive relative to stocks of REITs. It is not possible to predict whether the reduced 15% tax rate on certain corporate dividends will affect the market price of our common stock following this offering or what the effect will be.

In addition, legislation has been introduced from time to time that would amend certain rules relating to REITs. As of the date hereof, it is not possible to predict with any certainty whether any such legislation will be enacted.

**RISKS RELATED TO THIS OFFERING**

**The stock ownership limit imposed by our charter may inhibit market activity in our stock and may restrict our business combination opportunities.**

In order for us to maintain our qualification as a REIT under the Internal Revenue Code, not more than 50% in value of the outstanding shares of our capital stock may be owned, directly or indirectly, by five or fewer individuals (as defined in the Internal Revenue Code to include certain entities) at any time during the last half of each taxable year after our first REIT taxable year. Our charter, with certain exceptions, authorizes our directors to take such actions as are necessary and desirable to preserve our qualification as a REIT and provide that, unless exempted by our board of directors, no person may own more than 9.8% in value or in number of shares, whichever is more restrictive, of the aggregate of the outstanding shares of any class or series of our capital stock. Our directors also have authority under our charter to impose a similar ownership limitation as to any separate class or series of preferred stock we may issue in the future. Our board of directors may grant an exemption from that ownership limit in its sole discretion, subject to such conditions, representations and undertakings as it may determine that are consistent with ensuring compliance with the REIT provisions of the Internal Revenue Code. Our charter also prohibits anyone from buying shares if the purchase would result in us losing our REIT status. If you or anyone else acquires shares in excess of the ownership limit or in violation of the ownership requirements of the Internal Revenue Code for REITs, we:

Ø will consider the transfer to be null and void;

Ø will not reflect the transaction on our books;

Ø may institute legal action to enjoin the transaction;

Ø will not pay dividends or other distributions with respect to those shares;

Ø will not recognize any voting rights for those shares; and

Ø will consider the shares held in trust for the benefit of a charitable beneficiary as designated by us.

The trustee shall sell the shares held in trust and the owner of the excess shares will be entitled to the lesser of:

- (1) the price paid by the transferee;
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- (2) if the transferee did not purchase the excess shares, the closing price for the shares on the national securities exchange on which our common stock is listed or quoted on the day of the event causing the shares to be held in trust; or
- (3) the price received by the trustee from the sale of the shares.

This ownership limit could delay or prevent a transaction or a change in our control that might involve a premium price for our common stock or otherwise be in your best interest and may result in the entrenchment of our board of directors and management regardless of performance.

**We expect to enter into employment agreements with some of our executive officers that will provide them with benefits in the event their employment is terminated following a change of control.**

We intend to enter into employment agreements with members of our senior executive management team, including Messrs. Cole, Morrice, Gotschall, Flanagan and Rank and Ms. Dodge. These employment agreements will provide the executives with severance benefits if their employment ends under specified circumstances following a change in control. We may choose not to enforce, or to enforce less vigorously, our rights under these agreements because of our desire to maintain our ongoing relationship with the individuals involved. In addition, the severance benefits could increase the cost to a potential acquirer of us and thereby prevent or discourage a change of control that might involve a premium price for your shares or otherwise be in your best interest.

**Certain provisions of Maryland law and our charter and bylaws could hinder, delay or prevent a change in control of New Century REIT.**

Certain provisions of Maryland law and our charter and bylaws could have the effect of discouraging, delaying or preventing transactions that involve an actual or threatened change in control of us, and may have the effect of entrenching our management and members of our board of directors, regardless of performance. These provisions include the following:

- Ø **Classified board of directors.** Our board of directors will be divided into three classes with staggered terms of office of three years each. The classification and staggered terms of office of our directors will make it more difficult for a third party to gain control of our board of directors. At least two annual meetings of stockholders, instead of one, generally would be required to effect a change in a majority of our board of directors.
- Ø **Removal of directors.** Under our charter, subject to the rights of one or more classes or series of preferred stock to elect one or more directors, a director may be removed only for cause and only by the affirmative vote of at least two-thirds of all votes entitled to be cast by its stockholders generally in the election of directors.
- Ø **Number of directors, board vacancies, term of office.** Under our bylaws, we have elected to be subject to certain provisions of Maryland law which vest in the board of directors the exclusive right to determine the number of directors and the exclusive right, by the affirmative vote of a majority of the remaining directors, to fill vacancies on the board even if the remaining directors do not constitute a quorum. These provisions of Maryland law, which are applicable even if other provisions of Maryland law or the charter or bylaws provide to the contrary,

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also provide that any director elected to fill a vacancy shall hold office for the remainder of the full term of the class of directors in which the vacancy occurred, rather than the next annual meeting of stockholder as would otherwise be the case, and until his or her successor is elected and qualified.

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- Ø **Limitation on stockholder requested special meetings.** Our bylaws provide that our stockholders have the right to call a special meeting only upon the written request of the stockholders entitled to cast not less than a majority of all the votes entitled to be cast by the stockholders at such meeting.
- Ø **Advance notice provisions for stockholder nominations and proposals.** Our bylaws require advance written notice for stockholders to nominate persons for election as directors at, or to bring other business before, any meeting of our stockholders. This bylaw provision limits the ability of our stockholders to make nominations of persons for election as directors or to introduce other proposals unless we are notified in a timely manner prior to the meeting.
- Ø **Exclusive authority of our board to amend our bylaws.** Our bylaws provide that our board of directors has the exclusive power to adopt, alter or repeal any provision of the bylaws or to make new bylaws. Thus, our stockholders may not effect any changes to our bylaws.
- Ø **Preferred stock.** Under our charter, our board of directors has authority to issue preferred stock from time to time in one or more series and to establish the terms, preferences and rights of any such series of preferred stock, all without approval of our stockholders.
- Ø **Duties of directors with respect to unsolicited takeovers.** Maryland law provides protection for Maryland corporations against unsolicited takeovers by limiting, among other things, the duties of the directors in unsolicited takeover situations. The duties of directors of Maryland corporations do not require them to (1) accept, recommend or respond to any proposal by a person seeking to acquire control of the corporation, (2) authorize the corporation to redeem any rights under, or modify or render inapplicable, any stockholders rights plan, (3) make a determination under the Maryland Business Combination Act or the Maryland Control Share Acquisition Act, or (4) act or fail to act solely because of the effect of the act or failure to act may have on an acquisition or potential acquisition of control of the corporation or the amount or type of consideration that may be offered or paid to the stockholders in an acquisition. Moreover, under Maryland law the act of the directors of a Maryland corporation relating to or affecting an acquisition or potential acquisition of control is not subject to any higher duty or greater scrutiny than is applied to any other act of a director. Maryland law also contains a statutory presumption that an act of a director of a Maryland corporation satisfies the applicable standards of conduct for directors under Maryland law.
- Ø **Ownership limit.** In order to preserve our status as a REIT under the Internal Revenue Code, our charter generally prohibits any single stockholder, or any group of affiliated stockholders, from beneficially owning more than 9.8% of our outstanding common or preferred stock unless our board of directors waives or modifies this ownership limit.
- Ø **Maryland Business Combination Act.** The Maryland Business Combination Act provides that unless exempted, a Maryland corporation may not engage in business combinations, including mergers, dispositions of 10% or more of its assets, certain issuances of shares of stock and other specified transactions, with an interested stockholder or an affiliate of an interested stockholder for five years after the most recent date on which the interested stockholder became an interested stockholder, and thereafter unless specified criteria are met. An interested stockholder is generally a person owning or controlling, directly or indirectly, 10% or more of the voting power of the outstanding stock of a Maryland corporation. Our board of directors has adopted a resolution exempting us from this statute. However, our board of directors may repeal or modify this resolution in the future, in which case the provisions of the Maryland Business Combination Act will be applicable to business combinations between us and other persons.
- Ø **Maryland Control Share Acquisition Act.** Maryland law provides that control shares of a corporation acquired in a control share acquisition shall have no voting rights except to the extent approved by a vote of two-thirds of the votes eligible to be cast on the matter under the Maryland
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Control Share Acquisition Act. Control shares means shares of stock that, if aggregated with all other shares of stock previously acquired by the acquiror, would entitle the acquiror to exercise voting power in electing directors within one of the following ranges of the voting power: one tenth or more but less than one third, one third or more but less than a majority or a majority or more of all voting power. A control share acquisition means the acquisition of control shares, subject to certain exceptions. If voting rights or control shares acquired in a control share acquisition are not approved at a stockholders meeting, then subject to certain conditions and limitations, the issuer may redeem any or all of the control shares for fair value. If voting rights of such control shares are approved at a stockholders meeting and the acquiror becomes entitled to vote a majority of the shares of stock entitled to vote, all other stockholders may exercise appraisal rights. Our bylaws contain a provision exempting acquisitions of its shares from the Maryland Control Share Acquisition Act. However, our board of directors may amend its bylaws in the future to repeal or modify this exemption, in which case any of our control shares acquired in a control share acquisition will be subject to the Maryland Control Share Acquisition Act.

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## Special note about forward-looking statements

This prospectus and the documents incorporated by reference herein include forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. Forward-looking statements are those that predict or describe future events or trends and that do not relate solely to historical matters. You can generally identify forward-looking statements as statements containing the words believe, expect, will, anticipate, intend, estimate, project, plan, assume, or other similar expressions, although not all forward-looking statements contain these identifying words. Statements regarding the following subjects contained or incorporated by reference in this prospectus are forward-looking by their nature:

- ∅ our business strategy;
  
- ∅ our understanding of our competition;
  
- ∅ our ability to complete the merger, this offering and the concurrent private placement;
  
- ∅ market trends;
  
- ∅ projected sources and uses of funds from operations;
  
- ∅ potential liability with respect to legal proceedings; and
  
- ∅ potential effects of proposed legislation and regulatory action.

You should not place undue reliance on our forward-looking statements because the matters they describe are subject to known and unknown risks, uncertainties and other unpredictable factors, many of which are beyond our control. Our forward-looking statements are based on the information currently available to us and are applicable only as of the date on the cover of this prospectus or, in the case of forward-looking statements incorporated by reference, as of the date of the filing that includes the statement. New risks and uncertainties arise from time to time, and it is impossible for us to predict these matters or how they may affect us. Over time, our actual results, performance or achievements will likely differ from the anticipated results, performance or achievements that are expressed or implied by our forward-looking statements, and such difference might be significant and materially adverse to our stockholders or our noteholders. Such factors include, but are not limited to:

- ∅ those identified under Risk factors from pages 13 through 39;
  
- ∅ those identified from time to time in New Century Financial's public filings with the Securities and Exchange Commission;
  
- ∅ the negative impact of economic slowdowns or recessions;

- Ø the effect of changes in interest rates;
  - Ø our limited experience managing a REIT;
  - Ø the condition of the secondary markets for our products;
  - Ø our access to funding sources and our ability to renew, replace or add to our existing repurchase arrangements and existing credit facilities on terms comparable to the current terms;
  - Ø the assumptions underlying our residual values and repurchase allowances;
  - Ø the impact of new state or federal legislation or court decisions on our operations;
  - Ø the impact of new state or federal legislation or court decisions restricting the activities of lenders or suppliers of credit in our market;
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**Special note about forward-looking statements**

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- Ø an increase in the prepayment speed or default rate of our borrowers;
- Ø the effect of competition from finance and mortgage banking companies and from Internet-based lending companies;
- Ø our ability to adequately hedge our residual values;
- Ø the initiation of a margin call under our credit facilities;
- Ø the ability of our servicing operations to maintain high performance standards;
- Ø our ability to expand origination volume while maintaining low overhead;
- Ø our ability to attract and retain qualified employees, including, in particular, our senior executives;
- Ø our ability to adapt to and implement technological changes;
- Ø the stability of residential property values;
- Ø our ability to close our forward sale commitments;
- Ø management's ability to manage our growth and planned expansion; and
- Ø the outcome of litigation or regulatory actions pending against us.

We have no duty to, and do not intend to, update or revise the forward-looking statements in this prospectus after the date of this prospectus, even if subsequent events cause us to become aware of new risks or cause our expectations to change regarding the forward-looking matters discussed in this prospectus. We have identified some of the important factors that could cause future events to differ from our current expectations and they are described in this prospectus under the caption "Risk factors" as well as in our most recent Annual Report on Form 10-K, as amended, all of which you should review carefully. Please consider our forward-looking statements in light of those risks as you read this prospectus.

This prospectus contains market data, industry statistics and other data that have been obtained from, or compiled from, information made available by third parties. We have not independently verified their data.



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## Use of proceeds

We estimate that the net proceeds from this offering and the concurrent private placement will be approximately \$837.3 million, based on (1) the sale of 13,500,000 shares of our common stock at an assumed public offering price of \$63.00 per share, which is the midpoint of the price range set forth on the cover page of this prospectus, after deducting the underwriting discount and estimated offering expenses of approximately \$3.5 million payable by us and (2) the concurrent private placement of 586,338 shares of our common stock to an affiliate of Friedman Billings at a per share price equal to the assumed public offering price less the underwriting discount. If the underwriters exercise in full their option to purchase up to an additional 2,025,000 shares of our common stock in this offering, our net proceeds will be approximately \$958.2 million. We intend to use the net proceeds we receive from this offering and the concurrent private placement for general working capital purposes, substantially all of which will be used to build a portfolio of self-originated mortgage loans and, if necessary to maintain our REIT status, to purchase mortgage-related assets from third parties.

We may need a significant amount of time to fully invest the available net proceeds we receive from this offering and the concurrent private placement in our intended investments and to implement fully our leveraging strategy to increase the total amount of our investments to our desired level. Initially, we may invest a portion of our net proceeds from this offering and the concurrent private placement in interest-bearing, short-term, investment grade securities that are consistent with our intention to qualify as a REIT. We will not leverage our temporary investment in these securities. We expect these temporary investments to provide a lower net return than we hope to achieve from our long-term intended use of the net proceeds we receive from this offering and the concurrent private placement.

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**Table of Contents****Market prices of New Century Financial common stock**

New Century Financial's common stock has been quoted on the Nasdaq National Market under the symbol "NCEN" since its initial public offering in June 1997. The following table sets forth, for the periods indicated, the high and low bid prices for New Century Financial's common stock as quoted on the Nasdaq National Market:

	Common Stock Price	
	High	Low
Year ended December 31, 2002		
First Quarter	\$ 15.93	\$ 7.87
Second Quarter	23.32	14.16
Third Quarter	23.19	13.50
Fourth Quarter	18.74	10.89
Year ended December 31, 2003		
First Quarter	\$ 21.75	\$ 16.34
Second Quarter	34.06	20.68
Third Quarter	31.45	21.51
Fourth Quarter	41.04	28.27
Year ending December 31, 2004		
First Quarter	\$ 51.80	\$ 37.91
Second Quarter	\$ 50.76	\$ 38.50
Third Quarter (through September 23, 2004)	\$ 63.15	\$ 43.27

On April 5, 2004, the last full trading day prior to the public announcement of our plan to convert to a REIT, the closing sale price of New Century Financial's common stock, as reported on the Nasdaq National Market, was \$45.40 per share. On September 23, 2004, the latest practicable date before the printing of this prospectus, the closing sale price of New Century Financial's common stock, as reported on the Nasdaq National Market was \$62.75 per share. Such stock prices and the stock prices set forth above give effect to the three-for-two stock split effected by a stock dividend paid in July 2003. As of August 31, 2004, the number of holders of record of New Century Financial's common stock was 62 and the number of outstanding shares of New Century Financial's common stock was 34,047,884.

Our common stock has been approved for listing on the NYSE, subject to official notice of issuance. The historical trading prices of New Century Financial's common stock are not necessarily indicative of the future trading prices of our common stock because, among other things, the current stock price of New Century Financial reflects the current market valuation of New Century Financial's current business and assets and does not necessarily take into account the changes in New Century Financial's business and operations that may occur in connection with the merger and the other restructuring activities necessary for us to qualify as a REIT.

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## Distribution policy; the special E&P distribution

We expect to make regular quarterly distributions to our stockholders beginning in the fourth quarter of 2004. The actual timing and amount of such distributions, however, will be as determined and declared by our board of directors and will depend on our financial condition, earnings, and other factors, many of which are beyond our control. In order to maintain our qualification as a REIT under the Internal Revenue Code, we are required to distribute (within a certain period after the end of each year) at least 90% of our REIT taxable income for such year (determined without regard to the dividends paid deduction and by excluding net capital gain). After-tax earnings generated by our taxable REIT subsidiaries and not distributed to us are not subject to these distribution requirements and may be retained by such subsidiaries to provide for future growth, subject to the limitations imposed by REIT tax rules. To the extent that we do not distribute 100% of our REIT taxable income, we will be taxed on any undistributed amounts. In addition, we cannot assure you that we will have access to funds to meet the distribution and other REIT qualification requirements. We anticipate paying quarterly distributions during January, April, July and October of each year for the preceding quarter. We anticipate that distributions generally will be paid from cash available for distribution (generally equal to cash from operations and investing activities less capital expenditures and principal amortization on indebtedness); however, to the extent that cash available for distribution is insufficient to make such distributions, we intend to borrow funds from one of our subsidiaries or a third party in order to make distributions consistent with this policy. We cannot assure you as to the amount, if any, of future distributions.

In addition, in connection with our plan to qualify as a REIT, we may, if necessary, make an immaterial one-time special E&P distribution to our stockholders. Under the Internal Revenue Code, neither a REIT nor any of its qualified REIT subsidiaries is permitted to retain earnings and profits accumulated during years when the company or its predecessor was taxed as a C corporation. Therefore, in order to qualify as a REIT, we may be required to distribute the current and accumulated earnings and profits of New Century Credit that we succeed to, if any, by paying a one-time special distribution to our stockholders in cash. A national accounting firm is preparing, and will provide prior to the date of the merger, a computation of New Century Credit's earnings and profits for this purpose. Based on this computation, we will make the corresponding special one-time cash distribution, if required, in an amount that is intended to equal or exceed the earnings and profits, if any, that we will inherit from New Century Credit. Any such special E&P distribution will be declared in December 2004 and payable in January 2005 to our stockholders on the record date for such distribution. The investors in this offering will be eligible to receive the special E&P distribution if those investors hold our common stock on the applicable record date.

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## Capitalization

The following table sets forth:

Ø New Century Financial's actual capitalization as of June 30, 2004; and

Ø our capitalization as of June 30, 2004, as adjusted to give effect to the merger, the sale of shares of our common stock in this offering at an assumed public offering price of \$63.00 per share, after deducting the underwriting discount and estimated expenses payable by us in connection with this offering, the concurrent private placement of 586,338 shares of our common stock to an affiliate of Friedman Billings at a per share price equal to the assumed public offering price less the underwriting discount and the application of the net proceeds received by us in this offering as described under the heading "Use of proceeds."

You should read this table in conjunction with our audited consolidated financial statements, which are included elsewhere in or incorporated by reference into this prospectus.

	As of	
	June 30, 2004	
	Actual	As adjusted
	(in thousands, except share amounts)	
Financing on mortgage loans held for investment(1)	\$ 9,086,932	\$ 9,086,932
Convertible notes	205,349	205,349
Notes payable	30,485	30,485
	<u>9,322,766</u>	<u>9,322,766</u>
<b>Total long-term debt</b>	<b>9,322,766</b>	<b>9,322,766</b>
<b>Stockholders' equity:</b>		
Preferred stock, par value \$0.01: 7,500,000 shares authorized and no shares issued and outstanding actual; 10,000,000 shares authorized and no shares issued and outstanding as adjusted		
Common stock, par value \$0.01: 100,000,000 shares authorized and 33,905,609 shares issued and outstanding actual; 300,000,000 shares authorized and 47,991,947 shares issued and outstanding, as adjusted	\$ 340	\$ 480
Additional paid in capital	49,310	886,519
Accumulated other comprehensive income	16,591	16,591
Retained earnings, restricted	686,061	686,061
Treasury stock, at cost	(70)	(70)
Deferred compensation costs	(8,895)	(8,895)
	<u>743,337</u>	<u>1,580,686</u>
<b>Total stockholders' equity</b>	<b>\$ 743,337</b>	<b>\$ 1,580,686</b>
<b>Long-term debt and total stockholders' equity</b>	<b>\$ 10,066,103</b>	<b>\$ 10,903,452</b>



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- (1) Included in financing on mortgage loans held for investment and notes payable is \$1.8 billion and \$13.6 million, respectively, of financing which matures within one year of June 30, 2004.

The table above excludes the following shares:

Ø a total of 5,342,736 shares of our common stock issuable upon exercise of options outstanding on August 31, 2004 with a weighted-average exercise price of \$18.26 per share;

Ø a total of 591,225 shares of our common stock available for awards under our stock incentive plans as of August 31, 2004;

Ø up to 6,034,686 shares of common stock issuable as of August 31, 2004 upon the conversion of our 3.50% convertible senior notes due 2008 (subject to adjustments under the terms of the convertible notes); and

Ø up to 6,034,668 shares of common stock issuable as of August 31, 2004 upon the exercise of a warrant issued in connection with the issuance of the convertible notes.

Subsequent to the date as of which information is presented in the table above we granted an option to the underwriters of this offering to purchase up to 2,025,000 shares of our common stock from us, solely to cover over-allotments.

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## Dilution

Dilution in net tangible book value per share represents the difference between the amount per share paid by purchasers of the shares of our common stock issued by us in our offering and the net tangible book value per share of our common stock after giving effect to the merger and immediately after this offering. Net tangible book value per share represents the amount of our total tangible assets less our total liabilities, divided by the number of shares of our outstanding common stock, after giving effect to:

- Ø the issuance of shares of our common stock in connection with the merger; and
- Ø the sale of the common stock offered by us in this prospectus at an assumed public offering price of \$63.00 per share, after deducting the underwriting discount and commissions as described in "Use of proceeds" and estimated offering expenses, the concurrent private placement of 586,338 shares of our common stock to an affiliate of Friedman Billings at a per share price equal to the assumed public offering price less the underwriting discount and our receipt of approximately \$837.3 million in net proceeds from this offering and the concurrent private placement.

Assuming the merger was completed on June 30, 2004, our pro forma net tangible book value after this offering and the concurrent private placement would have been approximately \$1,568.0 million, or \$32.67 per share of common stock. This amount represents an immediate dilution in pro forma net tangible book value of \$30.33 per share of common stock to new investors. The following table illustrates this dilution.

Public offering price	\$ 63.00
Net tangible book value per share as of June 30, 2004	\$ 21.55
Increase in net tangible book value per share to existing stockholders attributable to new investors	\$ 11.12
Pro forma net tangible book value per share after this offering and the concurrent private placement	\$ 32.67
Dilution per share to new investors	\$ 30.33

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## The merger and related transactions

After the pricing of this offering but prior to the closing of this offering, NC Merger Sub will merge with and into New Century Financial pursuant to the agreement and plan of merger dated April 21, 2004, by and among New Century Financial, New Century REIT and NC Merger Sub, or the merger agreement. This discussion is qualified in its entirety by reference to the complete merger agreement, a copy of which is filed as an exhibit to the registration statement of which this prospectus is a part. We encourage you to read the merger agreement in its entirety. See Where you can find additional information about New Century REIT, Inc.

### STRUCTURE AND COMPLETION OF THE MERGER

We recently formed NC Merger Sub, of which we are the sole stockholder. The merger agreement provides that NC Merger Sub will merge with and into New Century Financial, whereupon the separate corporate existence of NC Merger Sub will cease and New Century Financial will be the surviving entity of the merger. Upon the effectiveness of the merger, each outstanding share of common stock of New Century Financial will be converted into one share of our common stock and we will assume all obligations to deliver securities under New Century Financial's incentive options. For a description of the treatment of the convertible senior notes of New Century Financial and the related call option and warrant, see Treatment of convertible senior notes and related call option and warrant. In connection with the merger, we will change our name to New Century Financial Corporation and will succeed to and continue to operate substantially all of the existing business of New Century Financial and its subsidiaries.

### OTHER EFFECTS OF THE MERGER

We expect the following to occur in connection with the merger:

- Ø **Stockholder rights.** The rights of our stockholders will be governed by the MGCL and our charter and bylaws. See also Description of our capital stock.
- Ø **Directors and officers.** The board of directors, committees of the board of directors and management of New Century Financial immediately prior to the merger will become our board of directors, committees of the board of directors and management.
- Ø **Benefit plans.** We will assume all of New Century Financial's stock incentive plans, including the 2004 Performance Incentive Plan, and all rights to acquire shares of New Century Financial common stock under any New Century Financial stock incentive plan will be converted into rights to acquire shares of our common stock pursuant to the terms of the stock incentive plans and the other related documents, if any.
- Ø **Convertible senior notes.** We will execute a supplemental indenture covering New Century Financial's 3.50% convertible senior notes due 2008. As a party to the indenture, we will be obligated to issue shares of our common stock upon conversion of any convertible notes not otherwise converted prior to the merger and the other restructuring activities necessary for us to qualify as a REIT.

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- Ø **Distributions.** We will assume all of New Century Financial's obligations with respect to any distributions to its stockholders that have been declared by New Century Financial but not paid prior to the completion of the merger. In addition, we may, if required, declare a special E&P distribution in December 2004 and make the special distribution in January 2005 to our stockholders on the record date for such distribution.
- Ø **NYSE listing of our common stock.** Our common stock has been approved for listing on the NYSE under the symbol NEW, subject to official notice of issuance.
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**The merger and related transactions**

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**COMPLETION OF THE MERGER**

The merger of NC Merger Sub with and into New Century Financial will become effective at the time the certificate of merger is accepted for filing by the Secretary of State of Delaware in accordance with the Delaware General Corporation Law, or the DGCL, or later if so specified in the certificate of merger. It is anticipated that the merger will be completed immediately after the pricing of this offering but prior to the closing of this offering.

**TREATMENT OF CONVERTIBLE SENIOR NOTES AND RELATED CALL OPTION AND WARRANT**

**Treatment of convertible senior notes**

On July 8, 2003 and July 14, 2003, New Century Financial issued \$210 million of convertible senior notes due July 3, 2008 pursuant to Rule 144A under the Securities Act. The convertible notes bear interest at a rate of 3.50% per year and, as of March 17, 2004, became convertible into New Century Financial common stock. The conversion rate of the convertible notes is subject to adjustment upon the occurrence of certain events, including the payment of certain dividends and distributions on New Century Financial common stock, the splitting of New Century Financial common stock, the combination of New Century Financial common stock and certain other events. In particular, the conversion rate adjusts if the quarterly dividend yield is above 0.4375%, which equates to an annualized dividend yield of 1.75%. Adjustments to the conversion rate resulting from quarterly cash dividends may not cause the conversion rate to exceed 35.3274 shares per \$1,000 principal amount of convertible notes, or 7,418,754 shares. As a result of the merger, the convertible notes will become convertible into shares of our common stock at the same conversion rate as is in effect on the date of the merger, subject to further adjustment upon the occurrence of certain events. In order to implement these provisions, New Century Financial and New Century REIT will execute a supplemental indenture at the closing of the merger.

On October 15, 2003, New Century Financial filed a registration statement with the Securities and Exchange Commission, which has become effective, to permit the public resale of the convertible notes and New Century Financial common stock issuable upon conversion of the convertible notes. In connection with this offering, we will further amend the registration statement to permit the public resale of the convertible notes and our common stock, rather than New Century Financial's common stock, issuable upon conversion of the convertible notes.

**Treatment of call option and warrant**

In connection with the issuance of the convertible notes, New Century Financial entered into two agreements whereby it simultaneously purchased a call option and sold a warrant relating to shares of its common stock. New Century Financial can exercise the call option at any time to acquire 6,034,675 shares of its common stock at a price of \$34.80 per share. The holder of the warrant can, for a limited period of time upon maturity of the convertible notes, exercise the warrant to purchase from New Century Financial up to 6,034,668 shares of its common stock at a price of \$47.59 per share, subject to certain anti-dilution and other customary adjustments. The warrant may be settled in cash, in shares of New Century Financial common stock or a combination of cash and shares, at the option of New Century Financial. As a result of the merger, the call option and warrant will only be exercisable for shares of our common stock rather than New Century Financial common stock. The calculation agent of the warrant can reduce the exercise price of the warrant to account for changes in volatility, expected dividends and broker's ability to

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margin and liquidity of our common stock relative to the shares of New Century Financial common stock.

After we qualify to be taxed as a REIT, we may explore transactions to repurchase the convertible notes or induce the noteholders to convert the convertible notes into shares of our common stock. We may also explore the possibility of exercising our call option, inducing exercise or cancellation of the warrant or otherwise settling the transactions with our counterparty.

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**The merger and related transactions**

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**ACCOUNTING CONSEQUENCES**

For accounting purposes, the merger will be treated as a recapitalization of New Century Financial with New Century REIT as the acquiror (a reverse merger). The accounting basis used to initially record the assets and liabilities in NC Merger Sub is the carryover basis of New Century Financial.

**MATERIAL U.S. FEDERAL INCOME TAX CONSEQUENCES OF THE MERGER**

The parties have structured the merger so that it is anticipated that the merger will qualify as a tax-free reorganization for U.S. federal income tax purposes. If the merger so qualifies, no gain or loss will be recognized by New Century Financial, NC Merger Sub or New Century REIT as a result of the merger.

This summary is general in nature and does not discuss all of the tax consequences to New Century Financial, NC Merger Sub, New Century REIT or to you that may result from the merger or related transactions. Accordingly, we strongly urge you to consult with your own tax advisor to determine the particular U.S. federal, state or local or foreign income or other tax consequences to you of these transactions.

For a discussion of the material U.S. federal income tax consequences of an investment in our common stock, see [Material U.S. federal income tax consequences](#) beginning on page 126.

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## Unaudited pro forma consolidated condensed financial information

The following tables present selected financial data from the unaudited pro forma consolidated statement of operations for the six months ended June 30, 2004 and year ended December 31, 2003 and from the unaudited pro forma consolidated balance sheet as of June 30, 2004. The unaudited pro forma consolidated statement of operations presents the effects of the anticipated transactions as though they occurred on January 1, 2004 and 2003, but calculated as they are expected to occur based on actual data as of June 30, 2004 and December 31, 2003. The unaudited pro forma balance sheet is presented as if the merger and the other restructuring activities necessary for us to qualify as a REIT, including this offering and the concurrent private placement, had occurred on June 30, 2004. The selected unaudited pro forma consolidated financial data are based on the estimates and assumption set forth in the notes to such statements, which are preliminary and have been made solely for the purposes of developing such pro forma information. The selected unaudited pro forma consolidated financial data are not necessarily indicative of the financial position or operating results that would have been achieved had the merger and the other restructuring activities necessary for us to qualify as a REIT, including this offering and the concurrent private placement, been completed as of the dates indicated, nor are they necessarily indicative of future financial position or operating results. This information should be read in conjunction with the New Century Financial historical consolidated financial statements and related notes included in or incorporated by reference into this prospectus.

The pro forma financial results assume that all relevant REIT qualifying tests, as dictated by Internal Revenue Service rules, were met for the entire year. We have not performed these calculations and it is unlikely that certain tests would have been met.

The payment of a quarterly distribution has not been reflected in the pro forma financial results. To qualify as a REIT, at least 90% of our REIT taxable income (determined without regard to dividends paid deductions and by excluding any net capital gain) is required to be distributed to our stockholders.

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**Table of Contents****Unaudited pro forma consolidated condensed financial information****New Century Financial Corporation****Unaudited pro forma consolidated condensed statement of operations****For the six months ended June 30, 2004**

(in thousands, except per share data)

	<b>As Reported for the Six Months Ended June 30, 2004</b>	<b>Pro Forma Adjustments</b>	<b>Pro Forma for the Six Months Ended June 30, 2004</b>
<b>Revenues:</b>			
Gain on sale of loans	\$ 417,027	\$	\$ 417,027
Interest income	334,905		334,905
Residual interest income	9,358		9,358
Servicing and other income	14,478		14,478
	<hr/>	<hr/>	<hr/>
<b>Total revenues</b>	<b>775,768</b>		<b>775,768</b>
<b>Expenses:</b>			
Personnel	189,966		189,966
Interest	123,270		123,270
General and administrative	72,976		72,976
Provision for loan losses on mortgage loans held for investment	36,981		36,981
Advertising and promotion	20,656		20,656
Professional services	13,066		13,066
	<hr/>	<hr/>	<hr/>
<b>Total expenses</b>	<b>456,915</b>		<b>456,915</b>
	<hr/>	<hr/>	<hr/>
<b>Earnings before income taxes</b>	<b>318,853</b>		<b>318,853</b>
Income taxes	129,231		129,231
	<hr/>	<hr/>	<hr/>
<b>Net earnings</b>	<b>\$ 189,622</b>	<b>\$</b>	<b>\$ 189,622</b>
	<hr/>	<hr/>	<hr/>
<b>Basic earnings per share</b>	<b>\$ 5.72</b>	<b>\$</b>	<b>\$ 4.02</b>
	<hr/>	<hr/>	<hr/>
<b>Diluted earnings per share</b>	<b>\$ 4.46</b>	<b>\$</b>	<b>\$ 3.36</b>
	<hr/>	<hr/>	<hr/>
Basic weighted average shares outstanding	33,129	14,086	47,215
Diluted weighted average shares outstanding	43,089	14,086	57,175

See accompanying notes to unaudited pro forma consolidated condensed financial statements.



**Table of Contents****Unaudited pro forma consolidated condensed financial information****New Century Financial Corporation****Unaudited pro forma consolidated condensed statement of operations****For the year ended December 31, 2003**

(in thousands, except per share data)

	<b>As Reported for the Year Ended December 31, 2003</b>	<b>Pro Forma Adjustments</b>	<b>Pro Forma for the Year Ended December 31, 2003</b>
<b>Revenues:</b>			
Gain on sale of loans	\$ 611,136	\$	\$ 611,136
Interest income	329,463		329,463
Residual interest income	24,228		24,228
Servicing income	11,139		11,139
	<hr/>	<hr/>	<hr/>
Total revenues	975,966		975,966
<b>Expenses:</b>			
Personnel	248,796		248,796
Interest	117,575		117,575
General and administrative	105,301		105,301
Provision for loan losses on mortgage loans held for investment	26,304		26,304
Advertising and promotion	26,118		26,118
Professional services	28,620		28,620
	<hr/>	<hr/>	<hr/>
Total expenses	552,714		552,714
	<hr/>	<hr/>	<hr/>
Earnings before income taxes	423,252		423,252
Income taxes	177,769		177,769
	<hr/>	<hr/>	<hr/>
Net earnings	\$ 245,483	\$	\$ 245,483
	<hr/>	<hr/>	<hr/>
Basic earnings per share	\$ 7.26	\$	\$ 5.12
	<hr/>	<hr/>	<hr/>
Diluted earnings per share	\$ 6.56	\$	\$ 4.77
	<hr/>	<hr/>	<hr/>
Basic weighted average shares outstanding	33,835	14,086	47,921
Diluted weighted average shares outstanding	37,410	14,086	51,496

See accompanying notes to unaudited pro forma consolidated condensed financial statements.



**Table of Contents****Unaudited pro forma consolidated condensed financial information****New Century Financial Corporation****Unaudited pro forma consolidated condensed balance sheet****As of June 30, 2004**

(in thousands, except share amounts)

	As Reported at June 30, 2004	Pro Forma Adjustments	Pro Forma at June 30, 2004
<b>Assets</b>			
Cash and cash equivalents	\$ 68,891	\$ 840,849	\$ 909,740
Restricted cash	322,369		322,369
Mortgage loans held for sale, net	4,784,222		4,784,222
Mortgage loans held for investment, net	9,146,472		9,146,472
Residual interests in securitizations	190,827		190,827
Mortgage servicing assets	1,373		1,373
Accrued interest receivable	42,880		42,880
Income taxes, net	67,953		67,953
Office property and equipment	38,609		38,609
Prepaid expenses and other assets	70,114		70,114
	<u>          </u>	<u>          </u>	<u>          </u>
Total assets	\$ 14,733,710	\$ 840,849	\$ 15,574,559
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Liabilities and Stockholders Equity</b>			
Credit facilities	\$ 4,439,518	\$	\$ 4,439,518
Financing on mortgage loans held for investment, net	9,086,932		9,086,932
Convertible notes, net	205,349		205,349
Notes payable	30,485		30,485
Accounts payable and accrued liabilities	228,089	3,500	231,589
	<u>          </u>	<u>          </u>	<u>          </u>
Total liabilities	13,990,373	3,500	13,993,873
	<u>          </u>	<u>          </u>	<u>          </u>
Stockholders equity:			
Preferred stock, \$0.01 par value. Authorized 7,500,000 shares; no shares issued and outstanding at June 30, 2004			
Common stock, \$0.01 par value. Authorized 100,000,000 shares; issued and outstanding 33,905,609 (actual) and 47,991,947 (pro forma) at June 30, 2004			
	340	140	480
Additional paid-in capital	49,310	837,209	886,519
Accumulated other comprehensive income	16,591		16,591
Retained earnings, restricted	686,061		686,061
	<u>          </u>	<u>          </u>	<u>          </u>
	752,302	837,349	1,589,651
Treasury stock, 2,500 shares at June 30, 2004, at cost held for investment	(70)		(70)
Deferred compensation costs	(8,895)		(8,895)
	<u>          </u>	<u>          </u>	<u>          </u>
Total stockholders equity	743,337	837,349	1,580,686
	<u>          </u>	<u>          </u>	<u>          </u>

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Total liabilities and stockholders equity	\$ 14,733,710	\$ 840,049	\$ 15,574,559
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See accompanying notes to unaudited pro forma consolidated condensed financial statements.

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**Unaudited pro forma consolidated condensed financial information**

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**New Century Financial Corporation**

**Notes to unaudited pro forma consolidated condensed financial statements**

**June 30, 2004 and December 31, 2003**

The unaudited pro forma consolidated condensed financial statements present our financial position as of June 30, 2004, and our historic results of operations for the six months ended June 30, 2004 and the year ended December 31, 2003 and the adjustments and adjusted financial position as of June 30, 2004 and the adjustments and adjusted results of operations for the six months ended June 30, 2004 and the year ended December 31, 2003, reflecting the following assumptions:

- (i) the sale of \$850.5 million in common stock in this offering at a price of \$63.00, which is the midpoint of the price range set forth on the cover page of this prospectus, net of underwriters' discount of 5.25% and estimated offering expenses of \$3.5 million;
- (ii) the sale of \$35.0 million in common stock in the concurrent private placement at the assumed public offering price less the underwriting discount; and
- (iii) no adjustment has been made to income tax expense for the six months ended June 30, 2004 or year ended December 31, 2003 because substantially all of the REIT portfolio acquisition transactions are expected to occur in the second half of 2004.

These adjustments do not necessarily reflect the actual changes that would have occurred if the merger and the other restructuring activities necessary for us to qualify as a REIT, including this offering had occurred in the first six months of 2004 or 2003 and, therefore, the pro forma consolidated condensed financial statements are not indicative of expected future financial position or operating results.

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**Table of Contents****Selected financial data**

The following table presents a summary of New Century Financial's historical consolidated financial data as of the dates and for the periods indicated.

The selected consolidated statements of operations for the fiscal years ended December 31, 2003, 2002, 2001, 2000 and 1999 and the balance sheet data as of December 31, 2003, 2002, 2001, 2000 and 1999 have been derived from New Century Financial's audited consolidated financial statements and related notes thereto incorporated by reference into this prospectus. The financial data for the six months ended June 30, 2004 and 2003 were derived from our unaudited consolidated financial statements and include, in the opinion of management, all normal and recurring adjustments necessary to present the data fairly for such periods. Such selected financial data should be read in conjunction with those financial statements and the notes thereto and with Management's discussion and analysis of financial condition and results of operations also included elsewhere herein.

The information in the following table may not be comparable to our operations on a going-forward basis because, among other things, we will not pay federal income tax on our REIT taxable income that we distribute to our stockholders and expect to pay quarterly distributions of at least 90% of our REIT taxable income. Therefore, our historical results and management's discussion of these results may not be indicative of our future performance.

Statement of operations data:	For the		For the Years Ended December 31,				
	Six Months Ended						
	June 30,		2003	2002	2001	2000	1999
	2004	2003	(Dollars in thousands, except per share data)				
<b>Revenues:</b>							
Gain on sales of loans	\$ 417,027	\$ 272,084	\$ 611,136	\$ 451,744	\$ 182,612	\$ 14,952	\$ 121,672
Interest income(1)	334,905	105,863	329,463	122,331	62,706	67,351	61,457
Residual interest income	9,358	12,684	24,228	31,723	36,356	49,868	27,385
Servicing income	13,649	5,821	11,139	432	10,616	30,092	23,428
Other income	829			16	1,046	1,653	
<b>Total revenues</b>	<b>775,768</b>	<b>396,452</b>	<b>975,966</b>	<b>606,246</b>	<b>293,336</b>	<b>163,916</b>	<b>233,942</b>
Expenses(1)	456,915	214,261	552,714	299,910	209,852	200,697	167,056
<b>Earnings (loss) before income taxes</b>	<b>318,853</b>	<b>182,191</b>	<b>423,252</b>	<b>306,336</b>	<b>83,484</b>	<b>(36,781)</b>	<b>66,886</b>
Income taxes (benefit)	129,231	75,637	177,769	126,636	35,464	(13,756)	27,377
<b>Net earnings (loss)</b>	<b>\$ 189,622</b>	<b>\$ 106,554</b>	<b>\$ 245,483</b>	<b>\$ 179,700</b>	<b>\$ 48,020</b>	<b>\$ (23,025)</b>	<b>\$ 39,509</b>
<b>Basic earnings (loss) per share</b>	<b>\$ 5.72</b>	<b>\$ 3.11</b>	<b>\$ 7.26</b>	<b>\$ 5.19</b>	<b>\$ 1.83</b>	<b>\$ (1.17)</b>	<b>\$ 1.73</b>
<b>Diluted earnings (loss) per share</b>	<b>\$ 4.46</b>	<b>\$ 2.83</b>	<b>\$ 6.56</b>	<b>\$ 4.62</b>	<b>\$ 1.52</b>	<b>\$ (1.17)</b>	<b>\$ 1.41</b>



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Dividend per share	\$	0.36	\$	0.14	\$	0.33	\$	0.13
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- (1) Interest income for the six months ended June 30, 2004 and 2003 includes \$176.8 million and \$15.9 million, respectively, related to interest earned on mortgage loans receivable held for investment. Expenses for the six months ended June 30, 2004 and 2003 include \$66.4 million and \$4.5 million, respectively, related to interest expense on financing of mortgage loans held for investment and \$37.0 million and \$7.7 million, respectively, related to the provision for loan losses on mortgage loans held for investment. Interest income for the year ended December 31, 2003 includes \$104.7 million related to interest earned on mortgage loans receivable held for investment. Expenses for that period include \$36.7 million related to interest expense on financing of mortgage loans held for investment and \$26.3 million related to the provision for loan losses on mortgage loans held for investment.

**Table of Contents****Selected financial data**

Balance sheet data:	As of June 30,		As of December 31,				
	2004	2003	2003	2002	2001	2000	1999
(Dollars in thousands)							
Cash and cash equivalents	\$ 68,891	\$ 169,085	\$ 269,540	\$ 176,669	\$ 100,263	\$ 10,283	\$ 4,496
Restricted cash	322,369	22,732	116,883	6,255	6,416		
Mortgage loans held for sale, net	4,784,222	2,138,347	3,422,211	1,920,396	1,011,122	400,089	442,653
Mortgage loans held for investment, net	9,146,472	1,187,617	4,745,937				
Residual interests in securitizations	190,827	211,469	179,498	246,964	306,908	361,646	364,689
Other assets	220,929	66,611	200,811	52,644	26,609	75,143	51,871
Total assets	14,733,710	3,795,861	8,934,880	2,402,928	1,451,318	847,161	863,709
Credit facilities	4,439,518	2,049,572	3,311,837	1,885,498	987,568	404,446	428,726
Financing on mortgage loans held for investment, net	9,086,932	1,161,299	4,686,323				
Convertible notes, net	205,349		204,858				
Residual financing					79,941	176,806	177,493
Subordinated debt					40,000	40,000	20,000
Other liabilities	258,574	115,153	189,851	130,880	96,048	63,760	64,527
Total liabilities	13,990,373	3,326,024	8,392,869	2,016,378	1,203,557	685,012	690,746
Total stockholders' equity	743,337	469,837	\$ 542,011	\$ 386,550	\$ 247,761	\$ 152,149	\$ 172,963

  

Operating statistics:	For the Six Months Ended June 30,		For the Years Ended December 31,				
	2004	2003(1)	2003(1)	2002	2001	2000	1999
(Dollars in thousands)							
Loan origination and purchase activities:							
Wholesale originations	\$ 18,781,248	\$ 9,561,251	\$ 25,187,569	\$ 12,392,562	\$ 5,068,466	\$ 3,041,761	\$ 2,894,517
Retail originations	1,910,975	931,217	2,195,269	1,808,934	1,176,505	1,110,596	1,185,747
Total loan originations and purchases	\$ 20,692,223	\$ 10,492,468	27,382,838	14,201,496	6,244,971	4,152,357	4,080,264
Average principal balance per loan	172	159	167	151	138	108	102
Percent of loans secured by first mortgages	96.5%	98.6%	98.6%	99.6%	99.3%	95.3%	96.7%
Weighted average initial loan-to-value ratio	84.4%	81.4%	82.1%	79.6%	78.7%	78.6%	78.8%
Originations by product type:							
ARMs	\$ 14,032,610	\$ 7,875,089	\$ 19,185,517	\$ 10,492,558	\$ 5,101,783	\$ 3,052,481	\$ 2,610,475
Fixed-rate mortgages	6,659,613	2,617,379	8,197,321	3,708,938	1,143,188	1,099,876	1,469,789
Weighted average interest rates:							
Fixed rate mortgages	7.0%	7.9%	7.3%	8.2%	9.5%	11.0%	10.2%
ARMs initial rates	6.8%	7.5%	7.3%	8.3%	9.4%	10.4%	9.8%
ARMs margin over index	5.5%	5.8%	5.8%	6.6%	6.6%	6.2%	6.2%
Secondary market transactions:							
Loans sold through whole loan transactions	\$ 13,803,821	\$ 9,036,341	\$ 20,835,105	\$ 12,419,687	\$ 4,723,350	\$ 3,133,205	\$ 1,033,006
Securitizations structured as sales	337,148			845,477	898,244	1,029,477	3,017,658
Loans acquired to securitize							(61,312)
Total sales	14,140,969	9,036,341	20,835,105	13,265,164	5,621,594	4,162,682	3,989,352
	3,457,776	1,206,015	4,946,781				

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Securitizations structured as  
financings

Total secondary market transactions	\$ 17,598,745	\$ 10,242,356	\$ 25,781,886	\$ 13,265,164	\$ 5,621,594	\$ 4,162,682	\$ 3,989,352
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(1) Certain amounts for prior year s presentation have been reclassified to conform to the current year presentation.

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## Management's discussion and analysis of financial condition and results of operations

*Because of the impact of taxes, distributions and the change in business focus following the merger and the other restructuring activities necessary for us to qualify as a REIT, our historical results of operations may not be comparable to the results of our operations following the merger and those activities.*

### **THE COMPANY**

New Century Financial is one of the nation's largest mortgage finance companies in terms of subprime loan volume, providing first and second mortgage products to borrowers nationwide through our subsidiaries. New Century Financial was incorporated in Delaware in November 1995 and commenced lending operations in February 1996. We offer mortgage products designed for borrowers who generally do not satisfy the credit, documentation or other underwriting standards prescribed by conventional mortgage lenders and loan buyers, such as Fannie Mae and Freddie Mac. In connection with our loan origination business, we originate and purchase loans on the basis of the borrower's perceived ability to repay the mortgage loan, the borrower's historical pattern of debt repayment and the amount of equity in the borrower's property (as measured by the borrower's LTV). We have been originating and purchasing these types of loans since 1996 and we have created a proprietary automated credit grading and pricing methodology that we believe, based upon our historical loan performance, gives us the ability to more effectively evaluate credit risk and more efficiently price our products.

Our borrowers generally have considerable equity in the property securing the loan (as evidenced by the average LTV of loans we originated in the first half of 2004 of 78.2%), but have impaired or limited credit profiles or higher debt-to-income ratios than traditional mortgage lenders allow. Our borrowers also include individuals who, due to self-employment or other circumstances, have difficulty verifying their income, as well as individuals who prefer the prompt and personalized service we provide. We originate and purchase loans through wholesale and retail channels. Wholesale loans are originated or purchased from independent mortgage brokers by the Wholesale Division of one of our wholly-owned subsidiaries, New Century Mortgage. We do not purchase bulk pools of loans from third parties, although we do purchase closed loans on a flow basis from our correspondent lenders. Retail originations are made through New Century Mortgage's network of branch offices and its centralized telemarketing unit. After originating or purchasing loans, we then sell those loans through whole loan sales or securitizations. We may structure securitizations as sales (off-balance sheet securitizations) or financings (on-balance sheet securitizations). Under the on-balance sheet securitization structure, we do not recognize a gain on sale at the time of the transaction, but rather recognize net interest income as payments are received on the underlying loans.

### **OVERVIEW**

Our origination business relies on our ability to originate and purchase mortgage loans at a reasonable cost and to sell a portion of those loans in the secondary mortgage market at prices that result in an attractive operating margin. We measure our operating margin as the sum of the price we receive for our loans, plus the net interest we earn for the period of time we hold the loans, less the cost to originate the loans. For the past several years we have executed a secondary marketing strategy that included a combination of both whole loan sales and securitizations of our loans.

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Loan origination volumes in our industry have historically fluctuated from year to year and are affected by such external factors as home values, the level of consumer debt and the overall condition of the economy. In addition, the premiums we received from the secondary market for our loans have also

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**Management s discussion and analysis of financial condition and results of operations**

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fluctuated, and have also been influenced by the overall condition of the economy and, more importantly, the interest rate environment. As a consequence, the business of originating and selling loans is cyclical.

Historically, we structured our securitizations as sales for financial reporting purposes, and the gain on sale from loans sold through securitizations was a significant percentage of our revenues. During 2003, we shifted our strategy to address the cyclical nature of our earnings with the goal of generating a more stable long-term earnings stream. Our principal strategy to achieve this goal is to hold loans on our balance sheet. Because our financing facilities are short-term in nature and generally do not allow loans to be financed through the facility for longer than 180 days, a securitization structure offers the most attractive means to finance loans on our balance sheet. Consequently, during 2003 we structured our securitizations as financings rather than sales. To support the goal of matching the timing of cash flows with the recognition of earnings on our loans, we make an initial cash investment so that the securitization trusts begin to return cash flow to us beginning in the first month following securitization. Therefore, we require cash and capital to make an initial investment, as well as to support the loans on our balance sheet. During 2003 and the first half of 2004, we sold roughly 80% of our loans through whole loan sales, providing the cash and capital to support the 20% we added to our balance sheet. Our goal is to continue to add mortgage loans to our balance sheet in order to reduce the reliance on the origination and sale of loans for earnings and cash flows.

While we expect to continue to grow the amount of mortgage loans on our balance sheet, a significant portion of our net income will still come from our origination franchise. Cash-out refinance loans were 62.1% of our total origination, home purchase loans were 32.4% and rate and term refinance loans were 5.5% in the first six months of 2004, compared to 63.2%, 21.0% and 15.8% in the first six months of 2003. Our geographic expansion and focus on increasing our home purchase business have resulted in the shift in mix between home purchase and rate and term refinancings. We believe that our current rate of business is sustainable and that our origination strategies and initiatives are consistent with that belief. If we are successful in maintaining this mix, our exposure to interest rate cyclicity will be reduced.

The principal metric we use to measure the value of the origination franchise is the operating margin described above, which has three components: (i) gain on sale of loans; (ii) net interest income; and (iii) loan origination or acquisition costs.

**Gain on sale of loans**

Gain on sale of loans is affected by the condition of the secondary market for our loans. This market has been very strong for at least the past two years, partly as a result of the interest rate environment (low short-term rates relative to long-term rates, also known as a steep yield curve). In the past few quarters, as interest rates began to rise, the underlying factors that affect secondary market pricing remained relatively stable. However, because we and other lenders did not necessarily raise the interest rates we charge our borrowers with the overall interest rate environment, pricing has declined, reducing overall gain on sale margins.

**Net interest income**

We typically hold our mortgage loans held for sale for a period of 30 to 45 days before they are sold in the secondary market. During that time, we earn the coupon rate of interest paid by the borrower and we pay interest to the lenders that provide our financing facilities. During 2003, the difference between these interest rates was typically in excess of 5%. More recently, the margin has decreased to between 4% and 5% as

short-term rates have increased greater than our average coupon rates. We manage the timing of

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our sales to optimize the net interest income we earn on the loans, while preserving the ability to sell the loans at the maximum price.

**Loan origination or acquisition costs**

We also measure and monitor the cost to originate our loans. Such costs include the points and fees we may pay to brokers or correspondents, net of fees we receive from borrowers, plus our operating expenses associated with the origination business. We typically refer to this as our loan acquisition costs. For the past few years, our loan acquisition costs have steadily decreased as a result of growth and technology initiatives. We continue to focus on reducing our loan acquisition costs so that we can maintain a strong operating margin in periods when the secondary market for our loans is not as favorable.

**Loan originations and purchases**

As of June 30, 2004, our Wholesale and Retail Divisions operated through 26 regional operating centers. The Wholesale Division originated or purchased \$18.8 billion in loans during the six months ended June 30, 2004. As of June 30, 2004, our Retail Division originated loans through 74 sales offices, including our centralized telemarketing unit. Our Retail Division originated or purchased \$1.9 billion in loans during the six months ended June 30, 2004.

During the six months ended June 30, 2004, cash-out refinance loans were 62.1% of our total loan originations, or approximately \$12.9 billion, home purchase loans were 32.4% of our loans and rate and term refinancing loans were 5.5%, compared to 63.2%, 21.0% and 15.8% in the first six months of 2003. Our geographic expansion and focus on increasing our home purchase have resulted in the shift in mix of business between home purchase and rate and term refinance. We believe that if we are successful in maintaining this mix of loan originations by type, our exposure to interest rate cyclically will be reduced.

For the six months ended June 30, 2004, full documentation loans as a percentage of total originations totaled \$10.9 billion or 52.9%, limited documentation loans totaled \$978.2 million, or 4.7%, and stated documentation loans totaled \$8.8 billion, or 42.4%. Full documentation loans generally require applicants to submit two written forms of verification of stable income for at least 12 months. Limited documentation loans generally require applicants to submit 12 consecutive monthly bank statements on their individual bank accounts. Stated income documentation loans are based upon stated monthly income if the applicant meets certain criteria. For the six months ended June 30, 2003, full documentation loans as a percentage of total originations totaled \$6.1 billion, or 57.8%, limited documentation loans totaled \$559.8 million, or 5.3%, and stated documentation loans totaled \$3.9 billion, or 36.9%.

As of December 31, 2003, our Wholesale and Retail Divisions operated through 20 regional operating centers. The Wholesale Division originated or purchased \$25.2 billion in loans during the year ended December 31, 2003. As of December 31, 2003, our Retail Division originated loans through 72 sales offices, including our centralized telemarketing unit. Our Retail Division originated or purchased \$2.2 billion in loans during the year ended December 31, 2003.



**Loan sales and securitizations**

One of our primary sources of revenue is the recognition of gain on sale of our loans through whole loan sales and from 1997 to 2002, through off-balance sheet securitizations. In a whole loan sale, we recognize and receive a cash gain upon sale. In an off-balance sheet securitization transaction structured

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as a sale for financial reporting purposes, we typically recognize a gain on sale at the time the loans are sold, and receive cash flows over the actual life of the loans. The use of a NIMS transaction concurrent with or shortly after an off-balance sheet securitization transaction allows us to receive a substantial portion of the gain in cash at the closing of the NIMS transaction, rather than over the actual life of the loans.

Since the first quarter of 2003, we have structured our securitizations as financings rather than sales. Such structures do not result in gain on sale at the time of the transaction, but rather yield interest income as the payments on the underlying mortgages are received. The following tables set forth secondary market transactions for the periods indicated (dollars in thousands):

	<b>Six Months Ended</b>		
	<b>June 30,</b>		
	<b>2004</b>	<b>2003</b>	
Premium whole loan sales	\$ 13,713,146	\$ 8,928,265	
Off-balance sheet securitizations	337,148		
<b>Total premium sales</b>	<b>14,050,294</b>	<b>8,928,265</b>	
Discounted whole loan sales	90,675	108,076	
<b>Total sales</b>	<b>14,140,969</b>	<b>9,036,341</b>	
On-balance sheet securitizations	3,457,776	1,206,015	
<b>Total secondary market transactions</b>	<b>\$ 17,598,745</b>	<b>\$ 10,242,356</b>	

  

	<b>For the Years Ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
	Premium whole loan sales	\$ 20,587,888	12,160,303
Securitizations structured as sales		845,477	898,244
<b>Total premium sales</b>	<b>20,587,888</b>	<b>13,005,780</b>	<b>5,621,594</b>
Discounted whole loan sales	247,217	259,384	
<b>Total sales</b>	<b>20,835,105</b>	<b>13,265,164</b>	<b>5,621,594</b>
Securitizations structured as financings	4,946,781		
<b>Total secondary market transactions</b>	<b>\$ 25,781,886</b>	<b>13,265,164</b>	<b>5,621,594</b>

**On-balance sheet securitizations**

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During the six months ended June 30, 2004, we completed two securitizations totaling \$3.5 billion, which were structured as on-balance sheet securitizations for accounting purposes under SFAS No. 140. On August 4, 2004, we completed a \$1.7 billion securitization structured as an on-balance sheet securitization, which is included in the balance of mortgage loans held for investment at June 30, 2004. The portfolio-based accounting treatment for securitizations structured as financings and recorded on-balance sheet is designed to more closely match the recognition of income with the receipt of cash payments. Also, this on-balance sheet securitization structure is consistent with our strategy to generate primarily cash-based earnings rather than non-cash gain on sale revenue. Because we do not record gain on sale revenue in the period in which the on-balance sheet securitization occurs, the use of such portfolio-based accounting structures will result in lower income in the period in which the securitization occurs than would a traditional off-balance sheet securitization. However, the recognition of income as interest payments are received on the underlying mortgage loans is expected to result in higher income

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**Management's discussion and analysis of financial condition and results of operations**

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recognition in future periods than would an off-balance sheet securitization. During the six months ended June 30, 2003, we completed two on-balance sheet securitizations totaling \$1.2 billion. During the year ended December 31, 2003, we completed five securitizations totaling \$4.9 billion, all of which were structured as on-balance sheet securitizations for accounting purposes under generally accepted accounting principles.

**Off-balance sheet securitizations**

During the six months ended June 30, 2004, we completed one off-balance sheet transaction totaling \$337.1 million, related to our investment in Carrington Mortgage Credit Fund I, LP. During the six months ended June 30, 2003, we did not complete any off-balance sheet securitization transactions.

In the first quarter of 2004, we invested \$2 million in Carrington Capital Management, LLC ( LLC ) and \$25 million in Carrington Mortgage Credit Fund I, LP ( Carrington ), which is sponsored by Carrington Capital Management, LLC. Carrington acquires individual and pooled single-family residential sub-prime loans and securitizes them in transactions structured as sales. Carrington then sells certain securities to the mortgage-backed securities market and retains other securities for investment. Carrington may acquire additional assets (including regular and residual interests, whole loans, participation certificates, grantor trust and trust certificates, warehousing and servicing interests) in either the primary or secondary markets. We are currently the sole investor in Carrington until additional capital is raised. One year following our investment, we may redeem our interest in Carrington on a quarterly basis. In addition, within one year of our initial investment in Carrington, the General Partner ( GP ) of Carrington Capital Management, LLC will purchase not less than three loan pools from us at current market rates on behalf of Carrington, totaling not less than \$750 million. We own 35% of LLC and are entitled to 35% of the net earnings paid as a dividend annually for a total of eight years. The GP will be entitled to an annual management fee of 1.5% as well as an incentive fee of 20% of annual net profits over a 7% preferred return. We are required to exchange our Class A (voting) interest in five years for the return of our capital and a contractually designated rate of return for Class B (non-voting) interests, which are callable at the end of year eight for \$1.00. The GP has advised us that it intends to register as an Investment Advisor and a Broker/Dealer. These investments are consolidated with our financial statements for financial reporting purposes. In May 2004, Carrington executed a securitization transaction structured as a sale rather than a financing, resulting in the addition of a residual interest totaling \$35.7 million. Further, as the securitization was a sale to third parties, we recognized a gain of \$13.5 million, which represents the premium paid to us by Carrington to acquire the pool of loans to securitize. This premium was based on market rates for similar transactions at the time of execution.

At the closing of an off-balance sheet securitization, we add to our balance sheet the residual interest retained based on our calculation of the present value of estimated future cash flows to be received by us. The residual interest we record consists of the overcollateralization, or OC, account and the net interest receivable, or NIR. Combined, these are referred to as the residual interests.

On a quarterly basis, we review the underlying assumptions to value each residual interest and adjust the carrying value of the securities based on actual experience and industry trends. To determine the residual asset value, we project cash flow for each security. To project cash flow, we use base assumptions for the constant prepayment rate, or CPR, and losses for each product type based on historical performance. We update each security to reflect actual performance to date and we adjust base assumptions for CPR and losses based on historical experience to project performance of the security from that date forward. We then use the London Interbank Offered Rate, or LIBOR, forward curve to project future interest rates and compute cash flow projections for each security. We then discount the projected cash flows at a rate



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commensurate with the risk involved. At June 30, 2004, for securitizations executed prior to 2004, we used discount rates of 12% for residual interests and 14% for residual interests through NIMS transactions. For the securitization completed during the second quarter of 2004, we utilize a discount rate of 14.5% on the estimated cash flows. There is not a NIMS transaction associated with the 2004 transaction. At December 31, 2003, we used discount rates of 12% for residual interests and 14% for residual interests through NIMS transactions.

During the six months ended June 30, 2004, as a result of our quarterly evaluation of the residual interests, we recorded a \$6.8 million decrease in the fair value of the residual assets. This fair value adjustment represents the change in the estimated present value of future cash flows from the residual interests. An upward fair value adjustment of \$1.6 million was made to the residual assets during the six months ended June 30, 2003.

During the years ended December 31, 2003 and 2002, as a result of our quarterly evaluation of the residual interests, we recorded a \$19.4 million decrease and a \$12.1 million increase in the fair value of the residual assets, respectively. These fair value adjustments represent the change in the estimated present value of future cash flows from the residual interests. During 2003, the prepayment rates on the loans underlying our residual interests were higher than expected as a result of the continued low interest rate environment and because we believe that the future outlook for interest rates will cause this trend to continue, we adjusted prepayment assumptions accordingly, resulting in a reduction in fair value. During 2002, we increased the loss and prepayment speed assumptions used to determine the value of our residual interests. However, the favorable interest rate environment, the current LIBOR forward curve, the repurchase of some delinquent loans from the trusts, and a decrease in the discount rate of 1% resulted in an increase in the value of the residual interests that more than offset the loss in value related to the higher loss and prepayment assumptions, resulting in a net increase in value of \$12.1 million.

**Discounted loan sales**

The following table illustrates the composition of discounted loan sales for each of the periods indicated (dollars in thousands):

	<b>For the Six Months Ended June 30,</b>			
	<b>2004</b>		<b>2003</b>	
	<b>Principal</b>	<b>Discount</b>	<b>Principal</b>	<b>Discount</b>
Repurchases from whole loan investors and other discounted sales	\$ 90,675	(7.4)%	\$ 105,319	(12.4)%
Elective pool repurchases			2,757	(63.5)
<b>Total discounted sales</b>	<b>\$ 90,675</b>	<b>(7.4)%</b>	<b>\$ 108,076</b>	<b>(13.7)%</b>

For the six months ended June 30, 2004, we sold \$90.7 million in loans that had been repurchased from or rejected by whole loan investors, compared to \$108.1 million in loans for the same period in 2003. Discounted sales as a percentage of whole loans sales declined to 0.66% for the six months ended June 30, 2004 from 1.20% for the six months ended June 30, 2003, as a result of lower repurchase rates in 2004. The total loss severity was 7.37% for the six months ended June 30, 2004, a decline of 46.2% compared to 13.69% for the six months ended June 30, 2003. Loss severity decreased primarily as a result of a stronger and more active secondary market for these types of loans in 2004.

There were no sales of loans repurchased from securitized pools during the first six months of 2004, compared to \$2.8 million in 2003. Such sales in 2003 resulted from loan repurchases in 2002, which were designed to manage triggers that disrupt cash flows to us as the residual holder.

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During the year ended December 31, 2003, we sold \$247.2 million in loans at a discount to their outstanding principal balance. These loans consisted of repurchased loans, loans with documentation defects or loans that were rejected by whole loan buyers because of certain characteristics. For the year ended December 31, 2002, discounted sales totaled \$259.4 million. On a percentage basis, discounted sales decreased from 2.0% of total sales in 2002 to 1.2% in 2003.

The following table illustrates the composition of discounted loan sales for each of the periods indicated (dollars in thousands):

	For the Years Ended December 31,			
	2003		2002	
	Principal	Discount	Principal	Discount
Repurchases from whole loan investors and other sales	\$ 244,460	(7.1)%	\$ 178,400	(17.3)%
Repurchases from securitized pools	2,757	(63.5)%	80,984	(34.1)%
<b>Total discounted sales</b>	<b>\$ 247,217</b>	<b>(7.7)%</b>	<b>\$ 259,384</b>	<b>(22.5)%</b>

Both the percentage of discounted sales due to repurchases from whole loan investors and the severity of the discount decreased during 2003. The volume on a percentage basis decreased as a result of fewer early payment defaults. The severity of loss decreased primarily as a result of a stronger and more active secondary market for these types of loans in 2003.

There were \$2.8 million in repurchases from securitized pools during the year ended December 31, 2003, compared to \$81.0 million of repurchases in 2002. Such repurchases in 2002 were designed to manage triggers that disrupt cash flows to us as the residual holder. Where delinquency and loss rates jeopardize the release of these cash flows, we generally repurchase loans from the pools. The pooling and servicing agreements require the repurchase of the most delinquent loans first, resulting in more severe discounts. While the losses we recognized as a result of these repurchases were no less severe than if the loans had remained in the securitization trust, buying the loans from the pools allowed us to preserve cash flow and residual value, as well as control the ultimate disposition of the loans.

**CRITICAL ACCOUNTING POLICIES**

We have established various accounting policies that govern the application of accounting principles generally accepted in the United States of America in the preparation of our financial statements. Certain accounting policies require us to make significant estimates and assumptions that may have a material impact on certain assets and liabilities or our results of operations, and we consider these to be critical accounting policies. The estimates and assumptions we use are based on historical experience and other factors which we believe to be reasonable under the circumstances. Actual results could differ materially from these estimates and assumptions, which could have a material impact on the carrying value of assets and liabilities and our results of operations.



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We believe the following are critical accounting policies that require the most significant estimates and assumptions that are subject to significant change in the preparation of our consolidated financial statements. These estimates and assumptions include, but are not limited to, the interest rate environment, the economic environment, secondary market conditions, and the performance of the loans underlying our residual assets and mortgage loans held for investment.

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For our mortgage loans held for investment, we establish an allowance for loan losses based on our estimate of losses inherent and probable as of our balance start date. We charge off uncollectible loans at the time of liquidation. We evaluate the adequacy of this allowance each quarter, giving consideration to factors such as the current performance of the loans, credit characteristics of the portfolio, the value of the underlying collateral and the general economic environment. In order to estimate an appropriate allowance for losses on loans held for investment, we estimate losses using static pooling, which stratifies the loans held for investment into separately identified vintage pools. Using historic experience and taking into consideration the factors above, we estimate an allowance for credit losses, which we believe is adequate for known and inherent losses in the portfolio of mortgage loans held for investment. Provision for losses is charged to our consolidated statement of operations. Losses incurred on mortgage loans held for investment are charged to the allowance.

The following table presents a summary of the activity for the allowance for losses on mortgage loans held for investment for the six months ended June 30, 2004 and 2003 (dollars in thousands):

	<b>June 30,</b>	
	<b>2004</b>	<b>2003</b>
Beginning balance	\$ 26,251	\$
Additions	36,981	7,686
Charge-offs	(1,925)	
	<u>\$61,307</u>	<u>\$ 7,686</u>

The allowance for losses on mortgage loans held for investment as a percentage of mortgage loans held for investment as of June 30, 2004 was approximately 0.7%.

**Residual interests in securitizations**

Residual interests in securitizations are recorded as a result of the sale of loans through securitizations that we structure as sales rather than financings, referred to as off-balance sheet securitizations. We may also sell residual interests in securitizations through what are sometimes referred to as net interest margin securities, or NIMS.

We generally structure loan securitizations as follows: First, we sell a portfolio of mortgage loans to a special purpose entity, or SPE, that has been established for the limited purpose of buying and reselling mortgage loans. The SPE then transfers the same mortgage loans to a Real Estate Mortgage Investment Conduit or Owner Trust (the REMIC or Trust), which is a qualifying special purpose entity (QSPE) as defined under Statement of Financial Accounting Standards No. 140 (SFAS 140). The Trust, in turn, issues interest-bearing asset-backed securities (the Certificates) generally in an amount equal to the aggregate principal balance of the mortgage loans. The Certificates are typically sold at face

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value and without recourse except that we provide representations and warranties customary to the mortgage banking industry to the Trust. One or more investors purchase the Certificates for cash. The Trust uses the cash proceeds to pay us the cash portion of the purchase price for the mortgage loans. The Trust also issues a certificate to us representing a residual interest in the payments on the securitized loans. In addition, we may provide a credit enhancement for the benefit of the investors in the form of additional collateral ( Over-collateralization Account or OC Account ) held by the Trust. The servicing agreements typically require that the OC Account be maintained at certain levels.

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At the closing of each off-balance sheet securitization, we remove from our consolidated balance sheet the mortgage loans held for sale and add to our consolidated balance sheet (i) the cash received, (ii) the estimated fair value of the interest in the mortgage loans retained from the securitizations ( Residuals ), which consist of (a) the OC Account and (b) the net interest receivable ( NIR ), and (iii) the estimated fair value of the servicing asset. The NIR represents the discounted estimated cash flows that we will receive in the future. The excess of the cash received and the assets retained over the carrying value of the loans sold, less transaction costs, equals the net gain on sale of mortgage loans recorded by us.

The NIMS transactions are generally structured as follows: First, we sell or contribute the Residuals to a SPE that has been established for the limited purpose of receiving and selling asset-backed residual interests-in-securitization certificates. Next, the SPE transfers the Residuals to the Trust and the Trust, which is a QSPE as defined under SFAS 140, in turn issues interest-bearing asset-backed securities (the Bonds and Certificates ). We sell the Residuals without recourse except that we provide representations and warranties to the Trust customary within the mortgage banking industry. One or more investors purchase the Bonds and Certificates, and the proceeds from the sale of the Bonds and Certificates, along with a residual interest certificate that is subordinate to the Bonds and Certificates, represent the consideration received by us for the sale of the Residuals.

At closing of each NIMS transaction, we remove from our consolidated balance sheet the carrying value of the Residuals sold and add to our consolidated balance sheet (i) the cash received and (ii) the estimated fair value of the portion of the Residuals retained, which consists of the NIR. The excess of the cash received and assets retained over the carrying value of the Residuals sold, less transaction costs, equals the net gain or loss on the sale of Residuals recorded by us.

We allocate our basis in the mortgage loans and Residuals between the portion of the mortgage loans and Residuals sold through the Certificates and the portion retained (the Residuals and servicing assets) based on the relative fair values of those portions on the date of sale. We may recognize gains or losses attributable to the changes in the fair value of the Residuals, which are recorded at estimated fair value and accounted for as held-for-trading securities. We are not aware of an active market for the purchase or sale of Residuals and, accordingly, we determine the estimated fair value of the Residuals by discounting the expected cash flows released from the OC Account (the cash out method) using a discount rate commensurate with the risks involved. For securitizations executed prior to 2004, we utilize a discount rate of 12.0% on the estimated cash flows released from the OC Account to value the Residuals through securitization transactions and 14.0% on the estimated cash flows released from the Trust to value Residuals through NIMS transactions. For the securitization completed during the second quarter of 2004, we utilize a discount rate of 14.5% on the estimated cash flows. There is not a NIMS transaction associated with the 2004 transaction.

We are entitled to the cash flows from the Residuals that represent collections on the mortgage loans in excess of the amounts required to pay the Certificates principal and interest, the servicing fees and certain other fees, such as trustee and custodial fees. At the end of each collection period, the aggregate cash collections from the mortgage loans are allocated first to the base servicing fees and certain other fees, such as trustee and custodial fees, for the period, then to the Certificate holders for interest at the pass-through rate on the Certificates plus principal as defined in the servicing agreements. If the amount of cash required for the above allocations exceeds the amount collected during the collection period, the shortfall is drawn from the OC Account. If the cash collected during the period exceeds the amount necessary for the above allocation, and there is no shortfall in the related OC Account, the excess is released to us. If the OC Account balance is not at the required credit enhancement level, the excess cash collected is retained in the OC Account until the specified level is achieved. We are restricted from using

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the cash and collateral in the OC Account. Pursuant to certain servicing agreements, we may use cash held in the OC Account to make accelerated principal paydowns on the Certificates to create additional excess collateral in the OC Account. The specified credit enhancement levels are defined in our servicing agreements as the OC Account balance expressed generally as a percentage of the current collateral principal balance. For NIMS transactions, we receive cash flows once the holders of the Bonds and Certificates created in the NIMS transaction are fully paid.

The Annual Percentage Rate, or APR, on the mortgage loans is relatively high in comparison to the pass-through rate on the Certificates. Accordingly, the Residuals described above are a significant asset. In determining the value of the Residuals, we estimate the future rates of prepayments, prepayment penalties that we will receive, delinquencies, defaults and default loss severity as they affect the amount and timing of the estimated cash flows. As of June 30, 2004, we estimate average cumulative losses as a percentage of the original principal balance of the mortgage loans of 1.35% to 4.15% for adjustable-rate securities and 2.09% to 5.23% for fixed-rate securities. These estimates are based on historical loss data for the loans, the specific characteristics of the loans, and the existence of mortgage insurance. While the range of estimated cumulative pool losses is fairly broad, the weighted average cumulative pool loss estimate for the entire portfolio of residual assets was 3.73% and 3.94% at June 30, 2004 and December 31, 2003, respectively. We estimate prepayments by evaluating historical prepayment performance of our loans and the impact of current trends. We use a prepayment curve to estimate the prepayment characteristics of the mortgage loans. The rate of increase, duration, severity, and decrease of the curve depends on the age and nature of the mortgage loans, primarily whether the mortgage loans are fixed or adjustable and the interest rate adjustment characteristics of the mortgage loans (6-month, 1-year, 2-year, 3-year, or 5-year adjustment periods). As of June 30, 2004, these prepayment curve and default estimates have resulted in weighted average lives of between 2.23 to 2.64 years for our adjustable-rate securities and 2.37 to 3.56 years for our fixed-rate securities executed prior to 2004. The estimates used in the 2004 Carrington securitization resulted in a blended weighted-average life of 5.89 years.

During the six months ended June 30, 2004, the Residuals provided \$27.5 million in cash flow to us. We perform an evaluation of the Residuals quarterly, taking into consideration trends in actual cash flow performance, industry and economic developments, as well as other relevant factors. For the six months ended June 30, 2004, we updated the models for actual performance and made some slight adjustments to the assumptions, resulting in a \$6.8 million downward fair value adjustment for the period.

The Bond and Certificate holders and their securitization trusts have no recourse to us for failure of mortgage loan borrowers to pay when due. Our Residuals are subordinate to the Bonds and Certificates until the Bond and Certificate holders are fully paid.

**Allowance for repurchase losses**

The allowance for repurchase losses on loans sold relates to expenses incurred due to the potential repurchase of loans or indemnification of losses based on alleged violations of representations and warranties which are customary to the mortgage banking industry. Generally, repurchases are required within 90 days from the date loans are sold. Occasionally, we may repurchase loans after 90 days have elapsed. Provisions for losses are charged to gain on sale of loans and credited to the allowance while actual losses are charged to the allowance. During 2003, the provision for repurchase losses decreased from prior periods as a result of improved historical experience, i.e., the percentage of loans repurchased and the losses resulting from such repurchases were lower than previous years and in previous years we elected to make significant repurchases of loans previously securitized. As of both June 30, 2004 and December 31, 2003, approximately \$6.8 billion of loans are subject to repurchase, representing loans sold during the second quarter of 2004 and the fourth quarter of 2003, respectively.



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**Gain on sale of loans**

We recognize gains or losses resulting from sales or securitizations of mortgage loans at the date of settlement based on the difference between the selling price for sales or securitizations and the carrying value of the related loans sold. Such gains and losses may be increased or decreased by the amount of any servicing-released premiums received. We defer recognition of non-refundable fees and direct costs associated with the origination of mortgage loans until the loans are sold.

We account for loan sales and securitizations as sales when we surrender control of the loans, to the extent that we receive consideration other than beneficial interests in the loans transferred in the exchange. Liabilities and derivatives incurred or obtained by the transfer of loans are required to be measured at fair value, if practicable. Also, we measure servicing assets and other retained interests in the loans by allocating the previous carrying value between the loans sold and the interest retained, if any, based on their relative fair values at the date of transfer.

**Income taxes**

New Century Financial and its subsidiaries file a consolidated federal income and combined state franchise tax returns. We utilize the asset and liability method of accounting for income taxes, under which deferred income taxes are recognized for the future tax consequences attributable to the differences between the financial statement values of existing assets and liabilities and their respective tax bases. We measure deferred tax assets and liabilities using enacted tax rates we expect to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. We recognize the effect on deferred taxes of a change in tax rates in income in the period that includes the enactment date. As and when taxing authorities review our tax filings, differences may arise. The impact of such reviews will be recorded when probable and estimable.

In determining the possible realization of deferred tax assets, we consider future taxable income from the following sources: (a) the reversal of taxable temporary differences, (b) future operations exclusive of reversing temporary differences, and (c) tax planning strategies that, if necessary, we would implement to accelerate taxable income into periods in which net operating losses might otherwise expire.

**Derivative instruments designated as hedges**

During the six months ended June 30, 2004 and the year ended December 31, 2003, we accounted for certain Euro Dollar Futures contracts previously designated and documented as hedges pursuant to the requirements of Financial Accounting Standard No. 133, Accounting for Derivative Instruments and Hedging Activities ( FAS 133 ). Pursuant to FAS 133 these Euro Dollar Futures contracts have been designated as hedging the exposure to variability of cash flows from our financing on mortgage loans held for investment attributable to changes in interest rates. Hedge accounting requires that the effective portion of the gain or loss in the fair value of a derivative instrument designated as a hedge be reported in other comprehensive income and the ineffective portion be reported in current earnings. Additionally, in June 2004, certain Euro Dollar Futures contracts were designated as hedges of the fair values of certain fixed-rate mortgage loans held for investment and certain mortgage loans held for sale, pursuant to SFAS 133. Hedge accounting requires that for a fair value hedge, changes in the fair value of the derivative instrument and changes in the fair value of the hedged asset or liability attributable to the hedged risk be reported in current earnings.





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The following tables set forth our results of operations as a percentage of total revenues for the periods indicated:

	<b>Six Months Ended June 30,</b>	
	<b>2004</b>	<b>2003</b>
<b>Revenues:</b>		
Gain on sale of loans	53.7%	68.6%
Interest income	43.2	26.7
Residual interest income	1.2	3.2
Servicing income	1.8	1.5
Other income	0.1	0.0
	<u>          </u>	<u>          </u>
Total revenues	100.0	100.0
Total expenses	58.9	54.0
	<u>          </u>	<u>          </u>
Earnings before income taxes	41.1	46.0
Income taxes	16.7	19.1
	<u>          </u>	<u>          </u>
Net earnings	24.4%	26.9%
	<u>          </u>	<u>          </u>

	<b>For the Years Ended December 31,</b>		
	<b>2003</b>	<b>2002</b>	<b>2001</b>
<b>Revenues:</b>			
Gain on sale of loans	62.6%	74.5%	62.2%
Interest income	33.8	20.2	21.4
Residual interest income	2.5	5.2	12.4
Servicing income	1.1	0.1	3.6
Other income	0.0	0.0	0.4
	<u>          </u>	<u>          </u>	<u>          </u>
Total revenues	100.0	100.0	100.0
Total expenses	56.6	49.5	71.5
	<u>          </u>	<u>          </u>	<u>          </u>
Earnings before income taxes	43.4	50.5	28.5
Income taxes	18.2	20.9	12.1
	<u>          </u>	<u>          </u>	<u>          </u>
Net earnings	25.2%	29.6%	16.4%
	<u>          </u>	<u>          </u>	<u>          </u>

As our portfolio of on-balance sheet securitizations increases, a greater percentage of our revenues is derived from interest income.

**SIX MONTHS ENDED JUNE 30, 2004 COMPARED TO SIX MONTHS ENDED JUNE 30, 2003**

**Originations and Purchases**

We originated and purchased \$20.7 billion in loans for the six months ended June 30, 2004, compared to \$10.5 billion for the six months ended June 30, 2003. For the six months ended June 30, 2004, full documentation loans as a percentage of total originations totaled \$10.9 billion, or 52.9%, limited documentation loans totaled \$978.2 million, or 4.7%, and stated documentation loans totaled \$8.8 billion, or 42.4%. The weighted average FICO score of our borrowers for the six months ended June 30, 2004 was 628. For the six months ended June 30, 2003, full documentation loans as a percentage of total originations totaled \$6.1 billion, or 57.8%, limited documentation loans totaled

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**Management s discussion and analysis of financial condition and results of operations**

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\$559.8 million, or 5.3%, and stated documentation loans totaled \$3.9 billion, or 36.9%. The weighted average FICO score of our borrowers for the six months ended June 30, 2003 was 598. Wholesale loan originations and purchases were \$18.8 billion, representing 90.8% of total originations and purchases for the six months ended June 30, 2004. Retail loan originations and purchases were \$1.9 billion, representing 9.2% of total originations and purchases for the six months ended June 30, 2004. For the same period in 2003, wholesale and retail originations and purchases totaled \$9.6 billion and \$931.2 million, respectively, representing 91.1% and 8.9% of total originations and purchases for that period. The increase in originations in 2004 is a result of incremental volume generated by our strategy to price competitively within our market in the face of a rising interest rate environment. This strategy resulted in the origination of an incremental volume of mortgage loans with higher FICO scores and a greater percentage of fixed rate product than our historical core business. In addition, we have continued our previously announced initiative to expand geographically, and are receiving additional contributions from operating centers opened during 2003.

During the first six months of 2004, our wholesale loan originations and purchases totaled \$18.8 billion, or 90.8% of our total loan production, compared to \$9.6 billion, or 91.1%, of our total loan production during the first six months of 2003. Of this production, cash-out refinance loans were 60.1%, home purchase loans were 35.3% and rate and term refinance loans were 4.6%, compared to 61.3%, 22.8% and 15.9% in the first six months of 2003. Further, total wholesale production for the six months ended June 30, 2004 consisted of \$13.1 billion, or 69.7%, of adjustable-rate loans, and \$5.7 billion, or 30.3%, of fixed rate loans. For the six months ended June 30, 2003, wholesale production consisted of \$7.2 billion, or 75.7%, of adjustable-rate loans, and \$2.3 billion, or 24.3%, of fixed rate loans. Our geographic expansion and focus on increasing our home purchase business have resulted in the shift in mix between home purchase and rate and term refinancings. We believe that our current mix of business is sustainable and that our origination strategies and initiatives are consistent with that belief. If we are successful in maintaining this mix, our exposure to interest rate cyclicity will be reduced.

For the six months ended June 30, 2004, full documentation loans as a percentage of wholesale originations totaled \$9.5 billion, or 50.7%, limited documentation loans totaled \$877.1 million, or 4.7%, and stated documentation loans totaled \$8.4 billion, or 44.6%. For the six months ended June 30, 2003, full documentation loans as a percentage of wholesale originations totaled \$5.4 billion, or 56.0%, limited documentation loans totaled \$503.5 million, or 5.2%, and stated documentation loans totaled \$3.7 billion, or 38.8%.

During the first six months of 2004, our Retail Division originated \$1.9 billion, or 9.2%, of our total loan production, compared to \$931.2 million, or 8.9%, of our total loan production during the first six months of 2003. This production consisted of \$1.6 billion, or 81.9%, of cash-out refinancings, \$80.7 million, or 4.2%, of home purchase financing, and \$264.4 million, or 13.9%, of rate and term refinancings. During the six months ended June 30, 2003, retail production consisted of \$774.9 million, or 83.2% of cash-out refinancings, \$20.1 million, or 2.2%, of home purchase financing, and \$136.2 million, or 14.6%, rate and term refinancings. Further, total retail production for the six months ended June 30, 2004 consisted of \$950.8 million, or 49.8%, of adjustable-rate loans, and \$960.2 million, or 50.2%, of fixed rate loans. For the six months ended June 30, 2003, retail production consisted of \$639.2 million, or 68.6%, of adjustable-rate loans, and \$292.0 million, or 31.4%, of fixed rate loans.

For the six months ended June 30, 2004, full documentation loans as a percentage of retail originations totaled \$1.4 billion, or 74.5%, limited documentation loans totaled \$101.1 million, or 5.3%, and stated documentation loans totaled \$386.1 million, or 20.2%. For the six months ended June 30, 2003, full documentation loans as a percentage of retail originations totaled \$712.5 million, or 76.5%, limited documentation loans totaled \$56.3 million, or 6.1%, and stated documentation loans totaled \$162.4 million, or 17.4%.

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Whole loan sales increased to \$14.1 billion for the six months ended June 30, 2004, from \$9.0 billion for the corresponding period in 2003, an increase of 56.5%. This increase is the result of an increased inventory of mortgage loans available for sale due to higher production volume, as well as favorable conditions in the whole loan sale market. In addition, we added approximately \$5.1 billion to our portfolio of mortgage loans held for investment during the first six months of 2004, compared to the addition of \$1.2 billion in mortgage loans held for investment in 2003, which is consistent with our goal of securitizing approximately 20% of our production through sales structured as financings and recorded on-balance sheet.

**Revenues**

Total revenues for the six months ended June 30, 2004, increased by 95.7% to \$775.8 million, from \$396.5 million for the same period a year ago. This increase was primarily due to a 53.3% increase in gain on sale of loans, a 216.4% increase in interest income and a 148.7% increase in servicing income, partially offset by a 26.2% decrease in residual interest income.

**Gain on Sale**

Gain on sale of loans increased to \$417.0 million, a 53.3% increase for the six months ended June 30, 2004, compared to the same period in 2003. The increase in gain on sale of loans was the result of loan sale volume increasing to \$14.1 billion in 2004 from \$9.0 billion in 2003, and lower losses on discounted sales, partially offset by a reduction in the net execution to 4.04% in 2004 from 4.28% in 2003. We anticipate prices in the second half of 2004 to be lower than recent levels, and for all of 2004 we expect our net execution to be between 3.50% and 3.75%. Net execution represents the premium paid to us by third party investors in whole loans sale transactions. It does not include premiums we pay to originate the loans, hedging gains or losses, fair value adjustments or net deferred origination fees. The components of the gain on sale of loans are illustrated in the following table (dollars in thousands):

	Six Months Ended	
	June 30,	
	2004	2003
Cash gain from loan sale transactions	\$ 554,061	\$356,034
Gain from securitization of loans (1)	13,452	
Non-cash gain from servicing asset		7,777
Cash gain on sale of servicing rights		24,110
Provision for repurchase losses	(3,184)	(4,413)
Fair value adjustment of residual securities	(6,770)	1,606
Non-refundable loan fees (2)	104,591	61,836
Premiums paid (3)	(131,460)	(84,262)
Origination costs	(114,700)	(83,900)
Hedging gains (losses)	1,037	(6,704)

Gain on sale of loans	\$ 417,027	\$ 272,084
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- (1) Gain from Carrington securitization transaction, which was structured as a sale.
  - (2) Non-refundable loan fees represent points and fees collected from borrowers.
  - (3) Premiums paid represent fees paid to brokers for wholesale loan originations and purchases.
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Interest income increased by 216.4% to \$334.9 million for the six months ended June 30, 2004, compared to \$105.9 million for the same period in 2003, primarily as a result of higher average balances of mortgage loans held for sale and mortgage loans held for investment.

Interest income on mortgage loans held for sale increased 75.8% to \$158.1 million for the six months ended June 30, 2004 versus \$89.9 million for the six months ended June 30, 2003, due mainly to higher average outstanding balances of unsold inventory, which resulted from higher production volume during the six months ended June 30, 2004. Interest income from mortgage loans held for investment from our on-balance sheet portfolio was \$176.8 million versus \$15.9 million, due to an increase in average balance to approximately \$5.1 billion for the six months ended June 30, 2004 versus approximately \$410 million for the six months ended June 30, 2003.

Changes in our net interest income are a function of changes in both interest rates and volumes of interest-earning assets and interest-bearing liabilities. The following table sets forth information regarding changes in our interest income and expense for the periods indicated. For each category of interest-earning assets and interest-bearing liabilities, we have provided information on changes attributable to:

∅ changes in volume changes in volume multiplied by comparative period rate;

∅ changes in rate changes in rate multiplied by comparative period volume; and

∅ changes in rate/volume changes in rate multiplied by changes in volume.

Interest-earning asset and interest-bearing liability balances used in the calculation represent quarterly average balances computed using the average of each month's daily average balance during the period indicated (dollars in thousands).

	<b>Six Months Ended June 30, 2004 Versus</b>			
	<b>June 30, 2003 Changes Due To</b>			
	<b>Volume</b>	<b>Rate</b>	<b>Rate/ Volume</b>	<b>Net</b>
Interest income:				
Mortgage loans held for sale	\$ 80,285	(6,408)	(5,723)	68,154
Mortgage loans held for investment	182,643	(1,740)	(19,989)	160,914
Cash and investments	203	(52)	(177)	(26)
	<u>263,131</u>	<u>(8,200)</u>	<u>(25,889)</u>	<u>229,042</u>
Change in interest income	263,131	(8,200)	(25,889)	229,042

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Interest expense:				
Credit facilities	31,424	(7,100)	(6,912)	17,412
Financing on mortgage loans held for investment	52,744	718	8,500	61,962
Convertible notes			4,250	4,250
Other borrowings	450	1,062	834	2,346
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Change in interest expense	84,618	(5,320)	6,672	85,970
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Change in net interest income	\$ 178,513	\$ (2,880)	\$ (32,561)	\$ 143,072
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

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**Residual Interest Income**

Residual interest income decreased 26.2% to \$9.4 million for the six months ended June 30, 2004, compared to \$12.7 million for the corresponding period in 2003, primarily as a result of the decrease in the average balance of residual interests in securitizations excluding the residual interest in securitization resulting from the Carrington securitization transaction.

**Servicing Income**

Servicing income increased to \$13.6 million for the six months ended June 30, 2004, from \$5.8 million for the six months ended June 30, 2003. This increase was due to a larger mortgage loan servicing portfolio during the six months ending June 30, 2004. While the total portfolio grew to \$20.9 billion as of June 30, 2004, the portion of the portfolio which contributes to servicing income was \$7.0 billion, consisting of \$0.6 billion of loans sold servicing retained, and \$6.4 billion of loans serviced for others on an interim basis pending transfer to investors. As of June 30, 2003, the total portfolio of loans serviced by us included \$0.5 billion of loans sold servicing retained and \$1.8 billion of loans serviced for others on an interim basis pending transfer to investors. We received an initial rating of RPS3, or average, from Fitch, in April 2004, and a rating of average from S&P in June 2004, which we believe will enable us to grow our servicing portfolio in the future through increased sales of loans on a servicing retained basis. We expect to service loans owned by third parties to take advantage of our technical capabilities, capitalization and economies of scale.

**Expenses**

Expenses increased 113.3% to \$456.9 million for the six months ended June 30, 2004, compared to \$214.3 million for the same period in 2003, due primarily to increases in personnel expenses, provision for losses on mortgage loans held for investment, and interest expense. Personnel expenses increased to \$190.0 million for the six months ended June 30, 2004, from \$99.6 million for the same period in 2003, an increase of 90.7%. The increase was due to growth in the number of employees, as well as higher commission and bonus expenses that are variable expenses dependent upon loan production volume and profits. Total staffing was 4,624 on June 30, 2004, compared to 2,973 on June 30, 2003, an increase of 55.5%. Provision for losses on mortgage loans held for investment increased to \$37.0 million for the six months ended June 30, 2004, from \$7.7 million for the same period in 2003, due to the increase in the portfolio of mortgage loans held for investment and related allowance for loan losses. We establish an allowance for loan losses based on our estimate of losses inherent and probable as of our balance sheet date. Mortgage loans held for investment grew from \$1.2 billion at June 30, 2003 to \$9.1 billion at June 30, 2004. Interest expense increased to \$123.3 million for the six months ended June 30, 2004, from \$37.3 million for the same period in 2003, primarily due to an increase in average outstanding balances on credit facilities due to higher production volume, the convertible debt, as well as interest expense on the increased financing of securitized mortgage loans. The average balance of our credit facilities increased from \$2.3 billion to \$4.5 billion; while our average borrowing rate on the credit facilities decreased from 2.85% for the six months ended June 30, 2003 to 2.22% for the comparable period in 2004. Our average balance of securitization bond financing increased from \$399 million for the six months ended June 30, 2003 to \$5.1 billion for the comparable period in 2004; and our average borrowing rate on the securitization bond financing grew slightly from 2.23% for the six months ended June 30, 2003 to 2.59% for the comparable period in 2004. The convertible debt balance at June 30, 2004 was \$210 million compared to zero at June 30, 2003.

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**Income Taxes**

Income taxes increased to \$129.2 million for the six months ended June 30, 2004, from \$75.6 million for the comparable period in 2003. This increase was due to a \$136.7 million increase in pretax income resulting from higher production volume and an additional provision of \$3.5 million related to the reversal of the 2002 California tax benefit from NC Residual II Corporation, our existing real estate investment trust, which holds our residual interests and certain mortgage loans held for investment, offset by the reversal of \$5.0 million of income tax expense previously provided and a decrease in the effective tax rate. During the second quarter of 2004, we resolved an Internal Revenue Service examination of our consolidated tax returns for the years 1998 through 2001. The conclusion of the examination resulted in the reversal of \$5.0 million of income tax expense previously provided. Further, the outcome of the examination allowed us to reduce our expected income tax rate to 41 percent from 42 percent. The combined impact of these adjustments in the second quarter of 2004 was \$8.2 million.

**YEAR ENDED DECEMBER 31, 2003 COMPARED TO YEAR ENDED DECEMBER 31, 2002**

**Originations and purchases**

We originated and purchased \$27.4 billion in loans for the year ended December 31, 2003, compared to \$14.2 billion for the year ended December 31, 2002, an increase of 92.8%. Wholesale loan originations and purchases were \$25.2 billion, or 92.0%, of total originations and purchases for the year ended December 31, 2003. Retail loan originations and purchases were \$2.2 billion, or 8.0%, of total originations and purchases for the year ended December 31, 2003. For the same period in 2002, wholesale and retail originations and purchases totaled \$12.4 billion, or 87.3%, and \$1.8 billion, or 12.7%, respectively, of total originations and purchases. The increase in volume is a result of our geographic expansion efforts, an increase in our market share, and a favorable interest rate environment. Wholesale volume grew more rapidly in 2003 than retail volume as a result of our focus on wholesale growth initiatives, resulting in a higher percentage of wholesale volume in 2003 than 2002.

**Loan sales and securitizations**

Whole loan sales increased to \$20.8 billion for the year ended December 31, 2003, from \$12.4 billion for the corresponding period in 2002, an increase of 67.7%. This increase is the result of higher production volume in 2003. In addition, we completed five on-balance sheet securitization transactions totaling \$4.9 billion during the year ended December 31, 2003, compared to one off-balance sheet securitization transaction totaling \$845.5 million in 2002.

**Revenues**

Total revenues for the year ended December 31, 2003 increased by 61.0% to \$976.0 million, from \$606.2 million for the year ended December 31, 2002. This increase resulted primarily from higher gain on sale of loans, interest income and servicing income in 2003, partially offset by

lower residual interest income in 2003. Each of these revenue categories is discussed below.

**Gain on sale.** Gain on sale of loans increased to \$611.1 million, a 35.3% increase for the year ended December 31, 2003, compared to the same period last year. The increase in gain on sale of loans was the result of higher loan sale volume as well as significantly lower losses on discounted sales.

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As indicated in the table below, gain from whole loan sales, non-refundable fees, premiums paid and origination costs increased in 2003 primarily as a result of the higher volume of production and loan sales in 2003 and lower losses on discounted sales, partially offset by lower average premiums in 2003. Discounted sales decreased on a percentage basis from 2.0% of total sales in 2002 to 1.2% in 2003. The severity of loss on discounted sales also decreased from 22.5% in 2002 to 7.7% in 2003. The trend in discounted sales reflects lower early payment default rates in 2003, as well as a stronger secondary market for discounted loans.

Provision for losses decreased from 2002 to 2003, partially as a result of lower discounted sale losses described above, as well as a sharp decrease in repurchases from securitized pools in 2003. See Discouraged loan sales.

	For the Years Ended December 31,	
	2003	2002
	(In thousands)	
Gain from whole loan sale transactions	\$ 861,310	562,049
Non-cash premium (discount) from securitization of loans		(12,051)
Cash gain from securitization of loans		57,081
Non-cash gain from servicing asset	7,777	14,882
Cash gain on sale of servicing rights		12,574
Securitization expenses		(2,706)
Accrued interest		(5,226)
Provision for losses	(5,868)	(50,654)
Fair value adjustment of residual interests	(19,363)	12,067
Non-refundable loan fees(1)	142,745	111,601
Premiums paid(2)	(182,765)	(101,816)
Origination costs	(182,100)	(118,050)
Hedging losses	(10,600)	(28,007)
	<u>          </u>	<u>          </u>
Gain on sales of loans	\$ 611,136	451,744
	<u>          </u>	<u>          </u>

(1) Non-refundable loan fees represent points and fees collected from borrowers.

(2) Premiums paid represent fees paid to brokers for wholesale loan originations and purchases.

**Interest income.** Interest income increased by 169.4% to \$329.5 million for the year ended December 31, 2003, compared to \$122.3 million for the same period in 2002, primarily as a result of higher average mortgage loans held for sale and the addition of a portfolio of mortgage loans held for investment. Interest income on mortgage loans held for sale accounted for \$102.5 million of the increase due to higher average outstanding balances of unsold inventory, which resulted from higher production volume in 2003. During 2003, interest income from mortgage loans held for investment from our on-balance sheet securitizations generated an additional \$104.7 million in interest income.

**Residual interest income.** Residual interest income decreased to \$24.2 million for the year ended December 31, 2003 from \$31.7 million for the corresponding period in 2002, a decrease of 23.7%, primarily as a result of a decrease in the average balance of residual interests in securitizations.

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**Servicing income.** Servicing income increased to \$11.1 million for the year ended December 31, 2003, from \$432,000 for the year ended December 31, 2002. This increase was due to the re-establishment of our loan servicing platform in the fourth quarter of 2002. The total portfolio of loans serviced by us was

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\$11.6 billion on December 31, 2003, consisting of \$3.4 billion of loans held for sale, \$5.1 billion of loans sold on a servicing retained basis, and \$3.1 billion of interim servicing. At December 31, 2002, the portfolio totaled \$4.0 billion and consisted of \$1.9 billion of loans held for sale, \$0.5 billion of loans sold servicing retained, and \$1.6 billion of interim servicing. Interim servicing represents loans sold to whole loan investors for which the servicing has not yet been transferred to the new investor.

**Expenses**

Operating expenses increased 84.3% to \$552.7 million for the year ended December 31, 2003, compared to \$299.9 million for the comparable period in 2002, due primarily to increases in personnel, interest expense, and professional services.

Personnel expenses increased to \$248.8 million for the year ended December 31, 2003, from \$149.1 million for the same period in 2002, an increase of 66.9%, as a result of increased staffing to accommodate higher loan origination and purchase volume. Total staffing was 3,752 on December 31, 2003, compared to 2,487 on December 31, 2002, an increase of 50.9%. In addition, personnel expenses increased in 2003 compared to 2002 as a result of higher commission expense in 2003 due to higher production volume.

Interest expense increased to \$117.6 million for the year ended December 31, 2003, from \$50.6 million for the same period in 2002, primarily due to an increase in average outstanding balances on our warehouse and aggregation lines due to higher production volume, as well as interest expense on the financing on the mortgage loans held for investment and convertible notes, partially offset by a lower average interest rate on our borrowings during 2003.

Professional services expense increased to \$28.6 million for the year ended December 31, 2003, from \$10.4 million for the same period in 2002, primarily due to increased legal and accounting fees. Legal and accounting fees increased as a result of an overall increase in our size, as well as an increase in litigation expenses due a legal dispute with a former employee, which was resolved in 2003.

**Income taxes**

Income taxes increased to \$177.8 million for the year ended December 31, 2003 from \$126.6 million for the comparable period in 2002. This increase resulted from greater pretax income resulting from our higher production and sales volume, combined with an increase in the effective tax rate to 42.0% for the year ended December 31, 2003, from 41.3% for the comparable period in 2002. The increase in the effective tax rate for 2003 was the result of a recent state tax law change that related to a captive real estate investment trust we established in 2002 as a subsidiary of NC Capital to hold our residual interests.

**YEAR ENDED DECEMBER 31, 2002 COMPARED TO YEAR ENDED DECEMBER 31, 2001**

**Originations and purchases**

We originated and purchased \$14.2 billion in loans for the year ended December 31, 2002, compared to \$6.2 billion for the year ended December 31, 2001, an increase of 129.0%. Wholesale loan originations and purchases were \$12.1 billion, or 85.3%, of total originations and purchases for the year ended December 31, 2002. Retail loan originations and purchases were \$2.1 billion, or 14.7%, of total originations and purchases for the year ended December 31, 2002. For the same period in 2001, wholesale and retail originations and purchases totaled \$5.1 billion, or 81.2%, and \$1.2 billion, or

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18.8%, respectively, of total originations and purchases. These increases are a result of our geographic expansion efforts, as well as an increase in our market share.

**Loan sales and securitizations**

Whole loan sales increased to \$12.4 billion for the year ended December 31, 2002, from \$4.7 billion for the corresponding period in 2001, an increase of 163.8%. This increase is the result of higher production volume in 2002 due to our geographic expansion, an increase in market share and a favorable interest rate environment, as well as an increase in the percentage of whole loan sales versus securitizations in 2002. Loans sold through whole loan sales represented 93.6% of total loan sales in the year ended December 31, 2002, compared to 84.0% for the corresponding period in 2001. Securitizations decreased to \$845.5 million for the year ended December 31, 2002, from \$898.2 million for the comparable period in 2001, a decrease of 5.9%.

**Revenues**

Total revenues for the year ended December 31, 2002 increased by 106.7% to \$606.2 million, from \$293.3 million for the year ended December 31, 2001. This increase resulted was higher primarily due to higher gain on sale of loans and interest income in 2002, which resulted from the higher production volume, and was partially offset by a decrease in servicing income.

**Gain on sale.** The components of the gain on sale of loans are illustrated in the following table (dollars in thousands):

	<b>For the Years Ended December 31,</b>	
	<b>2002</b>	<b>2001</b>
Gain from whole loan sale transactions	\$ 562,049	170,717
Gain from securitizations of loans	(12,051)	15,894
Cash gain from securitizations of loans	57,081	4,938
Non-cash gain from servicing asset	14,882	32,402
Cash gain on sale of servicing rights	12,574	11,273
Securitization expenses	(2,706)	(3,820)
Accrued interest	(5,226)	(4,455)
Provision for losses	(50,654)	(15,106)
Fair value adjustment of residual interests	12,067	
Non-refundable loan fees(1)	111,601	67,645
Premiums paid(2)	(101,816)	(30,242)
Origination costs	(118,050)	(60,700)
Hedging losses	(28,007)	(5,934)
<b>Gain on sales of loans</b>	<b>\$ 451,744</b>	<b>182,612</b>



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- (1) Non-refundable loan fees represent points and fees collected from borrowers.
  - (2) Premiums paid represent fees paid to brokers for wholesale loan originations and purchases.

**Interest income.** Interest income increased by 95.1% to \$122.3 million for the year ended December 31, 2002, compared to \$62.7 million for the same period in 2001, primarily as a result of higher average mortgage loans held for sale. Loan production volume was significantly higher in 2002, and the holding period for loans in 2002 was higher than in 2001.

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**Residual interest income.** Residual interest income decreased to \$31.7 million for the year ended December 31, 2002 from \$36.4 million for the corresponding period in 2001, a decrease of 12.9%, primarily as a result of the decrease in the average balance of residual interests in securitizations.

**Servicing income.** Servicing income decreased by 95.9% to \$432,000 for the year ended December 31, 2002, from \$10.6 million for the year ended December 31, 2001. This decrease resulted from the sale of servicing rights of \$4.8 billion in mortgage loans to Ocwen Federal Bank which began during the first quarter of 2001. The transfer of servicing rights to Ocwen occurred and was completed in August 2001. Subsequent to August 2001, we no longer received servicing fees and related income on this portion of our portfolio. While we re-established servicing operations in late 2002, servicing fee income was not significant in comparison to the servicing income received prior to the completion of our transfer of servicing rights to Ocwen.

**Expenses**

Operating expenses increased to \$299.9 million for the year ended December 31, 2002 from \$209.9 million for the comparable period in 2001, an increase of 42.9%. Personnel expenses increased to \$149.1 million for the year ended December 31, 2002 from \$83.4 million for the same period in 2001 as a result of higher loan origination and purchase volume. The increase in personnel expense was partially offset by a decrease in interest expense, to \$50.6 million for the year ended December 31, 2002 from \$54.1 million for the same period in 2001, primarily due to a significant decrease in the interest rates charged on our financing facilities. All other expense categories remained relatively the same in 2002 grew during 2002 in proportion to the growth of New Century Financial and production volume.

**Income taxes**

Income taxes increased to \$126.6 million for the year ended December 31, 2002 from \$35.5 million for the comparable period in 2001. This increase resulted from an increase in pretax income resulting from our higher production volume, partially offset by a decrease in the effective tax rate to 41.3% for the year ended December 31, 2002, from 42.5% for the comparable period in 2001. The decrease in the effective tax rate for 2002 was the result of the establishment of a captive REIT during 2002 to hold our residual interests in securitizations.

**Residual interests**

Residual interests in securitizations decreased to \$247.0 million at December 31, 2002, from \$306.9 million at December 31, 2001, a decrease of 19.5%. The decrease resulted from cash flows of over \$100 million received during the year ended December 31, 2002 that reduced the carrying value of residual interests.

During the year ended December 31, 2002, based on recent historical experience, we increased the loss assumptions used to determine the value of our residual interests. We also increased prepayment assumptions on our fixed-rate production. These changes were offset by a decrease in

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the discount rate and the current LIBOR forward curve, which increased the value of the residual interests. For the year ended December 31, 2002, we recorded a net \$12.1 million positive adjustment to the carrying value of the residuals. The components of the net positive adjustment include \$36.0 million attributable to the interest rate environment and \$14.0 million attributable to the decrease in discount rates, offset by \$38.0 million attributable to increases in prepayment and loss assumptions. We also recorded \$28.0 million in losses on the derivative instruments used to hedge our residual asset for the same period.

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**LIQUIDITY AND CAPITAL RESOURCES**

**Credit facilities**

We need to borrow substantial sums of money each quarter to originate and purchase mortgage loans. We need separate credit arrangements to finance these loans until we have aggregated one or more pools for sale. The amount of credit we seek to have available is based on our expectation of future origination volume.

During this year, we have used credit facilities with Bank of America, Bear Stearns, CDC Mortgage Capital, Citigroup Global Markets (formerly Salomon Brothers), Greenwich Capital Financial Products, Morgan Stanley, and UBS Real Estate Securities and we also have an asset-backed commercial paper facility. We use these facilities to finance the actual funding of our loan originations and purchases and to aggregate pools of mortgage loans pending sale through securitizations or whole loan sales. We typically sell all of our mortgage loans within one to three months and pay down the credit facilities with the proceeds.

Our credit facilities contain certain customary covenants, which, among other provisions, require us to maintain specified levels of liquidity, net worth and debt-to-equity ratios, restrict indebtedness and investments and require compliance with applicable laws. The maximum level of liquidity required under our credit facilities is \$60 million, the maximum amount of net worth required is approximately \$500 million, and debt-to-equity ratio requirements range from 10 to 1 to 15 to 1. We prepare compliance certificates on a monthly and quarterly basis to monitor the status of our compliance with the covenants. If we fail to comply with any of these covenants, the lender has the right to terminate the facility and require immediate repayment. In addition, if we default under one facility, it would generally trigger a default under our other facilities. The material terms and features of our various credit facilities are as follows:

**Asset-backed commercial paper facility.** In September 2003, we established a \$2.0 billion asset-backed commercial paper facility. This facility allows for the funding and aggregation of mortgage loans using funds raised through the sale of short-term commercial paper. The interest and fees that we pay in connection with this facility are similar to the interest rates based on LIBOR that we pay to our other credit facility lenders. This facility will expire in September 2006. As of June 30, 2004 and December 31, 2003, the balances outstanding under the facility were zero and \$409.1 million, respectively.

**Bank of America line of credit.** We have a \$2.0 billion credit facility with Bank of America, \$1.0 billion of which is committed and \$1.0 billion of which is uncommitted. The agreement allows for both funding of loan originations and aggregation of loans for up to four months pending their sale or securitization. The facility expires in May 2005 and bears interest based on a margin over the one-month LIBOR. As of June 30, 2004 and December 31, 2003, the balances outstanding under the facility were \$1.5 billion and \$697.2 million, respectively.

**Bear Stearns line of credit.** We have an \$800 million line of credit with Bear Stearns Mortgage Capital, \$400 million of which is committed and \$400 million of which is uncommitted. The facility expires in October 2004 and bears interest based on a margin over one-month LIBOR. This facility was temporarily increased to \$1.8 billion until the closing of our securitization transaction in August 2004. As of June 30, 2004 and December 31, 2003, the balances outstanding under this facility were \$1.6 billion and zero, respectively.

**CDC line of credit.** We have a repurchase agreement with CDC Mortgage Capital. The agreement allows for both funding of loan originations and aggregation of loans for up to six months pending their sale or securitization. The facility bears interest based on a margin over the one-month LIBOR. As of

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June 30, 2004, the maximum credit available under this facility was \$570 million. In June 2004, we entered into an amendment to this facility that temporarily increased the maximum credit available from \$570 million to \$700 million and on September 10, 2004, we extended the expiration date until September 9, 2005. As of June 30, 2004 and December 31, 2003, the balances outstanding under this facility were \$637.6 million and \$430.1 million, respectively.

**Greenwich Capital line of credit.** We had a \$100 million credit facility with Greenwich Capital Financial Products which expired in June 2004. The agreement allowed for both funding of commercial loan originations and aggregation of commercial loans for up to six months pending their sale or securitization. The facility bore interest based on a margin over the one-month LIBOR. As of June 30, 2004 and December 31, 2003, the balances outstanding under this facility were zero and \$20.3 million, respectively. We utilized the proceeds from our new Citigroup Commercial Loan Line of Credit to repay amounts outstanding on this line prior to its expiration.

**Morgan Stanley line of credit.** We also have a \$2.0 billion aggregation facility with Morgan Stanley Mortgage Capital. This facility expires in January 2005 and bears interest based on a margin over the one-month LIBOR. This facility was temporarily increased to \$3.0 billion from September 8, 2004 until September 30, 2004. As of June 30, 2004 and December 31, 2003, the balances outstanding under this facility were \$415,000 and \$284.6 million, respectively.

**Citigroup warehouse line of credit.** As of June 30, 2004, we had a \$150 million wet funding facility with Citigroup Global Markets (formerly Salomon Brothers), which bears interest based on a margin over the one-month LIBOR. This facility expires in September 2004. As of June 30, 2004 and December 31, 2003, the outstanding balance under the facility was zero. We expect to extend this facility or utilize the proceeds from a loan sale, an on-balance sheet securitization or another of our credit facilities to repay amounts outstanding on this line prior to its expiration.

**Citigroup aggregation line of credit.** As of June 30, 2004, we had a \$650 million aggregation facility with Citigroup Global Markets (formerly Salomon Brothers), which bears interest based on a margin over the one-month LIBOR. This facility expires in September 2004. The total amount outstanding among this and our other two Citigroup credit facilities may not exceed \$800 million. As of June 30, 2004 and December 31, 2003, the outstanding balances under this facility were \$634.0 million and \$468.8 million, respectively. We expect to extend this facility or utilize the proceeds from a loan sale, an on-balance sheet securitization or another of our credit facilities to repay amounts outstanding on this line prior to its expiration.

**Citigroup line of credit for delinquent and problem loans.** We also have a Master Loan and Security Agreement with Citigroup Global Markets (formerly Salomon Brothers) that is secured by delinquent or problem loans and by properties we obtain in foreclosures. This facility expires in December 2004 and bears interest based on a margin over the one-month LIBOR. As of June 30, 2004 and December 31, 2003, the outstanding balances under this facility were \$64.0 million and \$6.8 million, respectively. In May 2004, we entered into an amendment to this facility that increased the maximum credit available from \$50 million to \$75 million.

**Citigroup Commercial Loan Line of Credit.** In June 2004, we entered into a \$250 million repurchase agreement with Citigroup Global Markets. The agreement allows for both funding of commercial mortgage loan originations and aggregation of commercial mortgage loans for up to six months pending their sale or securitization. The facility expires in June 2005 and bears interest based on a margin over the one-month LIBOR. As of June 30, 2004, the balance outstanding under this facility was \$68.1 million.

**UBS Real Estate Securities, Inc. Line of Credit.** Our indirect special-purpose subsidiary, New Century Funding I, has a \$2.0 billion asset-backed note purchase and security agreement with UBS Real Estate

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Securities, \$1.5 billion of which is committed and \$0.5 billion of which is uncommitted. The agreement allows for both funding of loan originations and aggregation of loans for up to six months pending their sale or securitization. The facility bears interest based on a margin over the one-month LIBOR. As of June 30, 2004 and December 31, 2003, the balances outstanding under this facility were \$1.6 billion and \$994.8 million, respectively. The facility expires in June 2006 and bears interest based on a margin over the one-month LIBOR.

**Carrington Mortgage Credit Fund I, LP Citigroup Warehousing Agreement.** As of June 30, 2004, Carrington had a \$400 million uncommitted Warehouse Agreement with Citigroup Global Markets (formerly Salomon Brothers), which bears interest based on a margin over the one-month LIBOR. The agreement allows for both funding of loan originations and aggregation of loans for up to six months pending their sale or securitization. This facility expires in April 2005. As of June 30, 2004, the outstanding balance under this facility was \$9.1 million.

The information above, which appears in our annual report on Form 10-K, as amended, our quarterly reports on Form 10-Q and in our current reports on Form 8-K, provides information concerning certain credit facilities we have in place to finance our origination and purchase of mortgage loans. As a result of the merger and the other restructuring activities necessary for us to qualify as a REIT, we will need the consent of the various lenders discussed above in order for us to succeed to the rights of New Century Financial thereunder. In the event that such consents cannot be obtained, or can only be obtained on terms unfavorable to us, we will need to secure replacements for such credit facilities. While we do not believe we will be unable to secure either the receipt of the various consents or the replacement credit facilities on terms as favorable to us as our existing credit facilities, we cannot assure you that this will be the case and our failure to do so would harm our ability to originate and purchase mortgage loans, and could also harm our ability to make distributions required to maintain our REIT status, which would harm our results of operations, financial condition and business prospects.

**Convertible senior notes private offering**

On July 8, 2003, New Century Financial closed a private offering of \$175 million of convertible senior notes due July 3, 2008 pursuant to Rule 144A under the Securities Act. The convertible notes bear interest at a rate of 3.50% per year and, as of March 17, 2004, became convertible into New Century Financial common stock at a conversion price of \$34.80 per share. The conversion price represents a 28.0% premium over the closing share price on July 8, 2003. On July 14, 2003, the initial purchasers of the convertible notes exercised their option, in full, to acquire an additional \$35 million principal amount of the convertible notes. As a result of the merger, the convertible notes will become convertible into shares of our common stock.

As of June 30, 2004, the number of shares of our common stock into which these convertible notes may be convertible is 6,034,686, subject to certain adjustments under the terms of the convertible notes. In addition, the convertible debt term allows for the bondholder s conversion rate to adjust if the dividend rate increases generally above a dividend yield of 1.75%, subject to certain other factors. The maximum number of shares of our common stock into which these convertible notes may be convertible is 7,418,754, subject to certain adjustments under the terms of convertible notes.

In connection with the convertible debt transaction, New Century Financial entered into two agreements to simultaneously purchase a call option and sell a warrant on its common stock. New Century Financial can exercise the option that it purchased at any time to acquire 6,034,675 shares of its common stock at a strike price of \$34.80 per share. New Century Financial sold a warrant to an affiliate of one of the initial purchasers of the convertible notes. The holder of the warrant may exercise the warrant for a





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limited period of time upon maturity of the convertible notes to purchase from New Century Financial up to 6,034,668 shares of its common stock at a price of \$47.59 per share, subject to certain anti-dilution and other customary adjustments. The warrant may be settled in cash, in shares or in a combination of cash and shares, at the option of New Century Financial. Like the convertible notes, the option and the warrant will be exercisable for our common stock, rather than New Century Financial common stock, after the merger.

The convertible notes were only offered to qualified institutional buyers in accordance with Rule 144A under the Securities Act. New Century Financial filed a registration statement, which has become effective, to permit the public resale of the convertible notes and the common stock issuable under the convertible notes. In connection with this offering, we will further amend the registration statement to permit the public resale of the convertible notes and our common stock issuable upon conversion of the convertible notes.

**Other borrowings**

We periodically enter into equipment financing arrangements that are treated as notes payable for financial statement purposes. As of June 30, 2004, the balance outstanding under these borrowing arrangements was \$30.5 million. As of December 31, 2003, the balance outstanding under these borrowing arrangements was \$19.0 million.

During the third quarter of 2003, we entered into a \$20 million servicer advance agreement, which allows us to borrow up to 95% of servicing advances on our servicing portfolio. As of June 30, 2004, the balance outstanding under this facility was \$1.4 million. As of December 31, 2003, the balance outstanding under this facility was \$775,000 and was included in accounts payable and accrued liabilities. This facility expires in August 2005.

In connection with our conversion to a REIT, we expect that we will seek access to the capital markets from time to time in the future in order to satisfy our REIT distribution requirements, to support our operating activities and growth plans in our taxable REIT subsidiaries and for general working capital purposes. We currently anticipate offering approximately \$250 million to \$350 million aggregate principal amount of senior notes within approximately 30 to 60 days following completion of this offering, however, there is no assurance that we will do so. If we sell senior notes, we expect to enter into an indenture related to such senior notes which will contain customary covenants. In addition, if the offering is a private placement, we expect we will enter into a registration rights agreement and will agree to make an offer to exchange the senior notes for registered, publicly tradable notes that have substantially identical terms as such senior notes.

**On-balance sheet securitizations**

Prior to 2003, in our securitization transactions we realized net cash proceeds in an amount similar to whole loan sales, as a result of NIMS transactions closed concurrent with our securitizations. During the six months ended June 30, 2004, we completed two on-balance sheet securitizations, resulting in the recording of loans held for investment as an asset and financing on loans held for investment as a liability. Without a concurrent NIMS transaction, on-balance sheet securitizations generally require an initial cash investment ranging from approximately 2% to 4% of the principal balance of the loans. Immediately following the securitization, we start to receive interest payments on the underlying mortgage loans and pay interest payments to the bondholders, creating positive cash flow. As the loans age, losses on the portfolio will begin to reduce this cash flow. For the six months ending June 30, 2004,



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the initial cash investment for on-balance sheet securitizations was \$64.5 million. For the six months ending June 30, 2003, the initial cash investment for on-balance sheet securitizations was \$40.0 million. For the six months ending June 30, 2004 and 2003, we received \$127.4 million and \$11.6 million, respectively, in cash flows from our on-balance sheet securitizations.

During 2003, we completed five on-balance sheet securitizations, resulting in the recording of loans held for investment as an asset and financing on loans held for investment as a liability. Without a concurrent NIMS transaction, on-balance sheet securitizations generally require an initial cash investment ranging from approximately 2% to 4% of the principal balance of the loans. During 2003, we entered into four on-balance sheet securitizations that required initial cash investments ranging from \$14.6 to \$47.8 million. We also entered into one on-balance sheet securitization with a concurrent NIMS transaction, resulting in a nominal cash investment.

In January 2003, we completed an on-balance sheet securitization backed by \$494 million of fixed- and adjustable-rate mortgage loans originated by us. As a result of this on-balance sheet securitization, we maintained a restricted cash custodial account totaling \$18.3 million at June 30, 2004.

In July 2003, we completed an on-balance sheet securitization backed by \$712 million of fixed- and adjustable-rate mortgage loans originated by us. As a result of this on-balance sheet securitization, we maintained a restricted cash custodial account totaling \$43.4 million at June 30, 2004.

In September 2003, we completed an on-balance sheet securitization backed by \$1.5 billion of fixed- and adjustable-rate mortgage loans originated by us. As a result of this on-balance sheet securitization, we maintained a restricted cash custodial account totaling \$77.1 million at June 30, 2004.

In October 2003, we completed an on-balance sheet securitization backed by \$1.0 billion of primarily fixed-rate mortgage loans originated by us. As a result of this on-balance sheet securitization, we maintained a restricted cash custodial account totaling \$38.5 million at June 30, 2004.

In December 2003, we completed an on-balance sheet securitization backed by \$1.1 billion of fixed- and adjustable-rate mortgage loans originated by us. As a result of this on-balance sheet securitization, we maintained a restricted cash custodial account totaling \$52.4 million at June 30, 2004.

In April 2004, we completed an on-balance sheet securitization backed by \$1.5 billion of fixed- and adjustable-rate mortgage loans originated by us. As a result of this on-balance sheet securitization, we maintained a restricted cash custodial account totaling \$43.8 million at June 30, 2004.

In June 2004, we completed an on-balance sheet securitization backed by \$1.9 billion of fixed and adjustable rate mortgage loans originated by us. As a result of this on-balance sheet securitization, we maintained a restricted cash custodial account totaling \$11.2 million at June 30, 2004.

**Off-Balance Sheet Arrangements**

We are party to various transactions that have an off-balance sheet component. In connection with our off-balance sheet securitization transactions, as of June 30, 2004, \$1.5 billion in loans are owned by off-balance sheet trusts, including the loans securitized by Carrington. The trusts have issued bonds secured by these loans. The bondholders generally do not have recourse to us in the event that the loans in the various trusts do not perform as expected. Because these trusts are qualifying special purpose entities, in accordance with generally accepted accounting principles, we have included only our residual interest

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in these loans on our balance sheet. The performance of the loans in the trusts will impact our ability to realize the current estimated fair value of these residual assets. See [Loan Sales and Securitizations](#) for further discussion of the risks to us regarding these off-balance sheet arrangements.

As of June 30, 2004, in connection with our strategy to mitigate interest rate risk in our residual assets and our mortgage loans held for investment, we had approximately \$55.8 billion notional amount of Euro Dollar Futures contracts outstanding, which are scheduled to expire between September 2004 and March 2011.

As of December 31, 2003, in connection with our strategy to mitigate interest rate risk in our residual assets, our loans held for investment and our loans held for sale, we had approximately \$22.1 billion notional amount of Euro Dollar Futures contracts outstanding, which are scheduled to expire during the period from March 2004 through December 2005.

**Contractual Obligations**

The following table summarizes our material contractual obligations as of June 30, 2004 (dollars in thousands). The maturity of our financing on mortgage loans held for investment is based on certain prepayment assumptions (see [Results of Operations](#) for further details).

	Total	Payment Due By Period			
		Less than 1 Year	1 to 3 Years	3 to 5 Years	5+ Years
Notes payable	\$ 30,485	13,636	16,849		
Operating leases	85,356	29,161	43,239	12,215	741
Credit facilities	4,439,518	4,439,518			
Financing on mortgage loans held for investment	9,151,482	1,822,408	4,040,793	1,286,319	2,001,962

The following table summarizes our material contractual obligations as of December 31, 2003 (dollars in thousands):

	Total	Payment due by period			
		Less than 1 Year	1 to 3 Years	3 to 5 Years	More than 5 Years
Notes payable	\$ 18,977	8,987	9,990		
Operating leases	71,262	24,799	34,470	11,907	86
Credit facilities	3,311,837	3,311,837			
Financing on mortgage loans held for investment	4,727,555	977,014	2,156,868	674,198	919,475

**Stock repurchases**

For the six months ended June 30, 2004, we did not make any stock repurchases. For the year ended December 31, 2003, we repurchased a total of \$72.0 million of our common stock. There are 1.6 million shares authorized and not yet repurchased under our stock repurchase program.

Under certain circumstances, we may continue to fund stock repurchases with available corporate liquidity. Such purchases will be based upon the stock price, level of cash balances, general business conditions and other factors including alternative investment opportunities.

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**Cash flow**

For the six months ended June 30, 2004, our cash flow provided by operations was \$35.2 million, compared to cash used of \$64.6 million for the same period in 2003. This decrease was due primarily to a lower utilization of the borrowing capacity of \$166.9 million and NIR gains of \$21.9 million, deposits of \$10.9 million to over-collateralization accounts, for the six months ended June 30, 2004, offset by (i) \$83.1 million increase in net income, (ii) \$26.1 million increase in provision for losses (iii) \$81.1 million positive change in other assets and liabilities, and (iv) \$15.1 million higher principal payments received on mortgage loans held for sale.

For the six months ended June 30, 2004, our cash flow used in investing activities was \$2.7 billion compared to cash used of \$1.2 billion for the same period in 2003. This increase in cash used is due to \$3.5 billion of cash used to acquire mortgage loans for investment for the six months ended June 30, 2004, compared to \$1.2 billion in 2003, partially offset by \$739.3 million in payments received on our mortgage loans held for investment for the six months ended June 30, 2004, compared to \$23.8 million for the same period in 2003.

For the six months ended June 30, 2004, cash provided by financing activities was \$2.5 billion compared to \$1.1 billion for the six months ended June 30, 2003. This increase is due mainly to: (i) net financing on mortgage loans held for investment of \$3.3 billion in 2004 compared to \$1.2 billion in 2003; (ii) higher proceeds from fixed asset financing, (net of repayments) of \$15.7 million in 2004; and (iii) no stock repurchases in 2004 compared to \$24.2 million in 2003, offset by higher repayments of securitization financing on mortgage loans held for investment of \$633 million in 2004, and an increase in restricted cash of \$189.0 million in 2004.

For the year ended December 31, 2003, cash flow from operations was \$193.9 million, compared to \$257.1 million in 2002. This decrease is due primarily to (i) \$75 million in income tax payments in excess of the income tax expense for the year ended December 31, 2003 compared to \$11 million in income tax payments in excess of the income tax expense for the same period in 2002 and (ii) lower loan sales than loans funded in 2003, due in part to our on-balance sheet securitizations in 2003.

For the year ended December 31, 2003, cash used in investing activities was \$4.8 billion compared to \$24.3 million for the year ended December 31, 2002. This increase is due to loans acquired for investment for the five on-balance sheet securitizations completed in 2003.

For the year ended December 31, 2003, cash from financing activities was \$4.7 billion compared to a usage of \$156.4 million for the year ended December 31, 2002. This increase is due mainly to financing on mortgage loans held for investment and convertible debt proceeds during 2003, compared to the repayment of residual financing of \$80.0 million and subordinated debt of \$40.0 million in 2002, partially offset by an increase in stock repurchases from \$45.4 million in 2002 to \$72.0 million in 2003.

Our loan origination and purchase and servicing programs require significant cash investments, including the funding of: (i) fees paid to brokers and correspondents in connection with generating loans through wholesale lending activities; (ii) commissions paid to sales employees to originate loans; (iii) any difference between the amount funded per loan and the amount advanced under our credit facilities; (iv) servicing-related advance requirements; and (v) income tax payments arising from the timing differences between income for financial reporting purposes and taxable income. We also require cash to fund on-balance sheet securitizations, ongoing operating and administrative expenses, and capital expenditures. Our sources of operating cash flow include: (i) cash premiums obtained in whole loan sales; (ii) mortgage



origination income and fees; (iii) interest income; (iv) cash flows from residual interests in securitizations; and (v) servicing fee income.

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**Liquidity strategy**

We establish target levels of liquidity and capital based on a number of factors including our production volume, the condition of the secondary market for our loans and our current balance sheet.

We intend to continue to concentrate on maintaining our targeted liquidity levels. Our principal strategy is to effectively manage the percentage of loans sold through whole loan sales versus on-balance sheet securitizations, giving consideration to whole loan prices, the amount of cash required to finance on-balance sheet securitizations and dividend requirements. There can be no assurance that we will be able to achieve this goal and operate on a cash flow-neutral or cash flow-positive basis.

Subject to the various uncertainties described above, and assuming that we will be able to successfully execute our liquidity strategy, we anticipate that our liquidity, credit facilities and capital resources will be sufficient to fund our operations for the foreseeable future.

Cash and liquidity, which includes available borrowing capacity, was \$275.5 million at June 30, 2004 compared to \$212.7 million at June 30, 2003. Available borrowing capacity represents the excess of mortgage loan collateral pledged over the amount borrowed under our credit facilities.

**Newly issued accounting pronouncements**

In January 2003, the Financial Accounting Standards Board, or FASB, issued Interpretation 46, Consolidation of Variable Interest Entities, an interpretation of ARB No. 51 (FIN 46), which was subsequently amended in December 2003 by FIN 46R. FIN 46R requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or is entitled to receive a majority of the entity's residual returns, or both. Prior to FIN 46R, a company included another entity in its consolidated financial statements only if it controlled the entity through voting interests. The consolidation requirements of FIN 46R are applicable to variable interest entities created after December 31, 2003. For interests held in variable interest entities created before January 1, 2004, FIN 46R is applicable beginning on January 1, 2005. The assets, liabilities and noncontrolling interests of variable interest entities created before January 1, 2004 would initially be measured at their carrying amounts, with any difference between the net amount added to the balance sheet and any previously recognized interest being recognized as the cumulative effect of an accounting change. If determining the carrying amounts is not practicable, fair value at the date FIN 46R first applies may be used. Certain of our subsidiaries are qualifying special purpose entities formed in connection with off-balance sheet securitizations and are not subject to the requirements of FIN 46R. Our subsidiaries that are considered variable interest entities subject to the requirements of FIN 46R, namely our Trusts related to our on-balance sheet securitizations, are currently included in our consolidated financial statements. We do not expect that the application of FIN 46R will have a material impact on our consolidated balance sheet.

On April 30, 2003, the FASB issued Statement of Financial Accounting Standards No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities (SFAS 149). The purpose of SFAS 149 is to amend and clarify financial accounting and reporting for derivative instruments and hedging activities under SFAS No. 133. These amendments clarify the definition of a derivative, expand the nature of exemptions from SFAS No. 133, clarify the application of hedge accounting when using certain instruments, clarify the application of paragraph

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13 of SFAS No. 133 to embedded derivative instruments in which the underlying is an interest rate, and modify the cash flow presentation of derivative instruments that contain financing elements. SFAS 149 is effective for derivative transactions and hedging relationships entered into or modified after June 30, 2003. We quote interest rates to

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borrowers, which are generally subject to change by us. Although we typically honor such interest rate quotes, the quotes do not constitute interest rate locks, minimizing the potential interest rate risk exposure. The adoption of SFAS 149 did not have a material impact on our financial statements.

On May 15, 2003, the FASB issued Statement of Financial Accounting Standards No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity ( SFAS 150 ). SFAS 150 requires issuers to classify as liabilities (or assets in some circumstances) three classes of freestanding financial instruments that embody obligations for the issuer. SFAS 150 is generally effective for financial instruments entered into or modified after May 31, 2003, although certain of the provisions of SFAS 150 related to certain mandatorily redeemable noncontrolling interests have been deferred indefinitely. The adoption of SFAS 150 did not have a material impact on our financial statements.

In March 2004, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 105 ( SAB 105 ). SAB 105 contains specific guidance that significantly limits opportunities for registrants to recognize an asset related to a commitment to originate a mortgage loan that will be held for sale prior to funding the loan, which differs from the current accounting guidance provided by Statement of Financial Accounting Standards No. 149 ( SFAS 149 ). SFAS 149 requires that the entity that makes the mortgage loan commitment record the commitment on its balance sheet at fair value, but does not address how to measure the fair value of the loan commitment. SAB 105 requires that fair value measurement of loan commitments include only differences between the guaranteed interest rate in the loan commitment and a market interest rate, excluding any expected cash flows related to the customer relationship or loan servicing. SAB 105 is effective for new loan commitments accounted for as derivatives entered into after March 31, 2004. SAB 105 permits registrants to continue to use previously applied accounting policies to commitments entered into on or before March 31, 2004. We quote interest rates to borrowers, which are generally subject to change by us. Although we typically honor such interest rate quotes, the quotes do not constitute interest rate locks, minimizing the potential interest rate exposure. We do not account for our interest rate quotes as derivatives. Additionally, we do have an immaterial amount of interest rate locks outstanding at any balance sheet date and as a result, the application of SAB 105 has not had a material impact on our consolidated financial statements.

**Quantitative and qualitative disclosures about market risk**

We carry interest-sensitive assets on our balance sheet that are financed by interest-sensitive liabilities. Since the interval for re-pricing of the assets and liabilities is not matched, we are subject to interest-rate risk. A sudden, sustained increase or decrease in interest rates would impact our net interest income, as well as the fair value of our mortgage loans held for investment and related financing, and our residual interests in securitizations. We employ hedging strategies from time to time to manage the interest-rate risk inherent in our assets and liabilities. These strategies are designed to create gains when movements in interest rates would cause our cash flows and/or the value of our assets to decline, and result in losses when movements in interest rates cause our cash flows and/or the value of our assets to increase.

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Changes in market interest rates affect our estimations of the fair value of mortgage loans held for sale, and the fair value of our mortgage loans held for investment and related derivatives. Changes in fair value that are stated below are derived based upon immediate and equal changes to market interest rates of various maturities. The base or current interest rate curve is adjusted by the levels shown below (dollars in thousands):

As of June 30, 2004:

	<b>+ 50bp</b>	<b>+ 100bp</b>	<b>- 50bp</b>	<b>- 100bp</b>
Change in fair value of residual interests in securitizations	\$ (1,555)	(2,584)	2,050	4,936
Change in fair value of derivatives related to residual interests in securitizations	1,425	2,850	(1,425)	(2,850)
Change in fair value of mortgage loans held for investment	(59,655)	(109,207)	44,886	96,802
Change in fair value of derivatives related to mortgage loans held for investment	48,288	96,575	(48,288)	(96,575)
<b>Net change</b>	<b>\$ (11,497)</b>	<b>(12,366)</b>	<b>(2,777)</b>	<b>2,313</b>

As of December 31, 2003:

	<b>+ 50bp</b>	<b>+ 100bp</b>	<b>- 50bp</b>	<b>- 100bp</b>
Change in fair value of residual interests in securitizations	\$ (3,937)	(7,055)	4,596	9,886
Change in fair value of derivatives related to residual interests in securitizations	3,275	6,550	(3,275)	(6,550)
Change in fair value of mortgage loans held for investment	(30,302)	(62,629)	28,915	56,785
Change in fair value of derivatives related to mortgage loans held for investment	24,325	48,650	(24,325)	(48,650)
<b>Net change</b>	<b>\$ (6,639)</b>	<b>(14,484)</b>	<b>5,911</b>	<b>11,471</b>

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The following table illustrates the timing of the maturity of our interest-sensitive assets and liabilities as of June 30, 2004. We have made certain assumptions in determining the timing of the maturity of such assets and liabilities. One of the more significant assumptions is that all of our mortgage loans held for sale will be sold within six months. In addition, the timing of the maturity of our mortgage loans held for investment and related financing and our residual interests in securitizations is based on certain prepayment and loss assumptions. See Results of operations for further details. We purchase Euro Dollar Futures contracts designed to mitigate interest rate risk associated with our residual interests in securitizations, our portfolio of mortgage loans held for investment and certain of our mortgage loans held for sale. The Euro Dollar Futures contracts had a notional value of \$55.8 billion, their fair value was a gain of \$14.0 million and they had maturity dates of less than seven years at June 30, 2004.

Description	Zero to		1-2	3-4	5-6	Thereafter	Total
	six months	Six months to one year	Years	Years	Years		
(dollars in thousands)							
Interest-sensitive assets:							
Cash and cash equivalents	\$ 68,891						68,891
Restricted cash	322,369						322,369
Loans receivable held for sale, net	4,784,222						4,784,222
Mortgage loans held for investment, net (1)	634,058	1,156,185	2,573,800	2,266,401	969,829	1,546,199	9,146,472
Cap Contracts	2,655		397	1,711			4,763
Euro Dollar Futures contracts:							
Trading	165	71					236
Non-trading	4,646	5,773	5,074	(328)	(1,125)	(274)	13,766
Residual interests in securitizations	11,776	12,290	42,122	96,669	20,664	7,306	190,827
<b>Total interest-sensitive assets</b>	<b>5,828,782</b>	<b>1,174,319</b>	<b>2,621,393</b>	<b>2,364,453</b>	<b>989,368</b>	<b>1,553,231</b>	<b>14,531,546</b>
Interest-sensitive liabilities:							
Credit facilities	4,439,518						4,439,518
Financing on mortgage loans held for investment	672,003	1,150,405	2,531,330	2,293,256	941,323	1,498,615	9,086,932
Notes payable	6,685	6,951	11,113	5,736			30,485
Convertible notes				205,349			205,349
<b>Total interest-sensitive liabilities</b>	<b>5,118,206</b>	<b>1,157,356</b>	<b>2,542,443</b>	<b>2,504,341</b>	<b>941,323</b>	<b>1,498,615</b>	<b>13,762,284</b>
Excess of interest-sensitive assets over interest-sensitive liabilities	710,576	16,963	78,950	(139,888)	48,045	54,616	769,262
<b>Cumulative net interest-sensitivity gap</b>	<b>\$ 710,576</b>	<b>727,539</b>	<b>806,489</b>	<b>666,601</b>	<b>714,646</b>	<b>769,262</b>	<b>769,262</b>

(1) Treats mortgage loans held for investment to be securitized during the third quarter 2004 as if securitization occurred June 30, 2004.

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The following table illustrates the timing of the maturity of our interest-sensitive assets and liabilities as of December 31, 2003. We have made certain assumptions in determining the timing of the maturity of such assets and liabilities. One of the more significant assumptions is that all of our mortgage loans held for sale will be sold in the first six months of 2004. In addition, the timing of the maturity of our mortgage loans held for investment and related financing and our residual interests in securitizations is based on certain prepayment and loss assumptions. See

Results of operations for further details. We purchase Euro Dollar Futures contracts designed to mitigate interest rate risk associated with our residual interests in securitizations and our portfolio of mortgage loans held for investment. The Euro Dollar Futures contracts had a notional value of \$22.1 billion, their fair value was a loss of \$7.9 million and they had maturity dates of less than three years at December 31, 2003. At December 31, 2002 the Euro Dollar Futures contracts had a notional value of \$3.4 billion, their fair value was a loss of \$4.6 million and they had maturity dates of less than two years.

Description	Zero to	Six months to one Year	1-2	3-4	5-6	Thereafter	Total	Fair value
	Six Months		Years	Years	Years			
(dollars in thousands)								
Interest-sensitive assets:								
Cash and cash equivalents	\$ 269,540						269,540	269,540
Restricted cash	116,883						116,883	116,883
Mortgage loans held for sale, net	3,422,211						3,422,211	3,535,353
Mortgage loans held for investment, net	426,976	589,793	1,402,794	722,691	390,294	1,213,389	4,745,937	4,924,441
Residual interests in securitizations	13,428	5,875	36,139	14,071	61,556	48,429	179,498	179,498
<b>Total interest-sensitive assets</b>	<b>4,249,038</b>	<b>595,668</b>	<b>1,438,933</b>	<b>736,762</b>	<b>451,850</b>	<b>1,261,818</b>	<b>8,734,069</b>	<b>9,025,715</b>
Interest-sensitive liabilities:								
Credit facilities	3,311,837						3,311,837	3,311,837
Financing on mortgage loans held for investment	377,212	575,609	1,402,310	762,843	398,554	1,169,795	4,686,323	4,686,323
Notes payable	4,768	4,219	7,212	2,778			18,977	18,977
Convertible Notes					204,858		204,858	204,858
Euro Dollar Futures contracts:								
Trading	1,211	544	311				2,066	2,066
Non-trading	2,352	1,970	1,476				5,798	5,798
<b>Total interest-sensitive liabilities</b>	<b>3,697,380</b>	<b>582,342</b>	<b>1,411,309</b>	<b>765,621</b>	<b>603,412</b>	<b>1,169,795</b>	<b>8,229,859</b>	<b>8,229,859</b>
Excess of interest-sensitive assets over interest-sensitive liabilities	551,658	13,326	27,624	(28,859)	(151,562)	92,023	504,210	795,856
<b>Cumulative net interest-sensitivity gap</b>	<b>\$ 551,658</b>	<b>564,984</b>	<b>592,608</b>	<b>563,749</b>	<b>412,187</b>	<b>504,210</b>		<b>795,856</b>

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The following table illustrates the timing of the maturity of our interest-sensitive assets and liabilities as of December 31, 2002. Management has made certain assumptions in determining the timing of the maturity of such assets and liabilities. One of the more significant assumptions is that all of our mortgage loans held for sale will be sold in the first six months of 2003. In addition, the timing of the maturity of our residual interests in securitizations is based on certain prepayment and loss assumptions. See Results of operations. We purchase Euro Dollar Futures contracts designed to mitigate interest rate risk associated with our residual interests in securitizations. The Euro Dollar Futures contracts had a notional value of \$3.4 billion, their fair value was a loss of \$4.6 million and they had maturity dates of less than two years at December 31, 2002. At December 31, 2001 the Euro Dollar Futures contracts had a notional value of \$7.1 billion, their fair value was a loss of \$2.9 million and they had maturity dates of less than two years.

Description	Zero to	Six Months	1-2	3-4	5-6	Thereafter	Total	Fair value
	Six Months	to one Year	Years	Years	Years			
(dollars in thousands)								
Interest-sensitive assets:								
Cash and cash equivalents	\$ 176,669						176,669	176,669
Restricted cash	6,255						6,255	6,255
Mortgage loans held for sale, net	1,920,396						1,920,396	1,974,833
Residual interests in securitizations	38,482	10,130	13,651	12,887	54,121	117,693	246,964	246,964
<b>Total interest-sensitive assets</b>	<b>2,141,802</b>	<b>10,130</b>	<b>13,651</b>	<b>12,887</b>	<b>54,121</b>	<b>117,693</b>	<b>2,350,284</b>	<b>2,404,721</b>
Interest-sensitive liabilities:								
Credit facilities	1,885,498						1,885,498	1,885,498
Notes payable	4,190	3,593	5,349	3,567			16,699	16,699
Euro Dollar Futures contracts:								
Trading	4,152	445					4,597	4,597
Non-trading								
<b>Total interest-sensitive liabilities</b>	<b>1,893,840</b>	<b>4,038</b>	<b>5,349</b>	<b>3,567</b>			<b>1,906,794</b>	<b>1,906,794</b>
<b>Excess of interest-sensitive assets over interest-sensitive liabilities</b>	<b>247,962</b>	<b>6,092</b>	<b>8,302</b>	<b>9,320</b>	<b>54,121</b>	<b>117,693</b>	<b>443,490</b>	<b>497,927</b>
<b>Cumulative net interest-sensitivity gap</b>	<b>\$ 247,962</b>	<b>254,054</b>	<b>262,356</b>	<b>271,676</b>	<b>325,797</b>	<b>443,490</b>		<b>497,927</b>



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## Our business

*The information in this section assumes that the merger has been completed, and that New Century REIT has succeeded to and is continuing the business of New Century Financial.*

### NEW CENTURY REIT

New Century REIT was formed as a Maryland corporation on April 12, 2004. To date, New Century REIT has not conducted any activities other than those incident to its formation, the execution of the merger agreement and the preparation of the documents related to the merger and the related transactions, including this prospectus. Upon completion of the merger, New Century Financial will be a wholly-owned subsidiary of New Century REIT. New Century REIT will be renamed New Century Financial Corporation and will continue the business of New Century Financial. We anticipate that New Century REIT will elect to be taxed as a REIT for U.S. federal income tax purposes commencing with its taxable year ending December 31, 2004. At the time of the merger, the then-current directors and officers of New Century Financial, including the three directors elected at the annual meeting of stockholders, will become the directors and officers of New Century REIT.

We are the nation's second largest subprime mortgage finance company in terms of loan volume. We originate, purchase, retain, sell and service primarily first mortgage products to borrowers nationwide. We focus on lending to individuals whose borrowing needs are generally not fulfilled by traditional financial institutions because they do not satisfy the credit, documentation or other underwriting standards prescribed by conventional mortgage lenders and loan buyers, such as Fannie Mae and Freddie Mac. We originate and purchase loans on the basis of the borrower's ability to repay the mortgage loan, the borrower's historical pattern of debt repayment and the amount of equity in the borrower's property, as measured by the borrower's LTV. We have been originating and purchasing subprime loans since 1996 and believe we have developed a comprehensive and sophisticated process of credit evaluation and risk-based pricing that allows us to effectively manage the potentially higher risks associated with this segment of the mortgage industry. In 2003, we retained approximately 20% of our loan production for investment through on-balance sheet securitizations. We expect that after we qualify as a REIT, we will increase the percentage of our net income generated from our mortgage loan portfolio in a tax-efficient manner and have the ability to produce a more diverse base of earnings across a variety of interest rate environments.

### BUSINESS STRATEGY

Our business objective is to pursue growth while also seeking to provide more stable, predictable earnings even when the origination environment becomes less favorable. We intend to execute this strategy by:

- Ø **Strengthening our production franchise.** We plan to pursue expansion into new geographic markets. We intend to continue to expand our total loan production and increase market share and volume on the East Coast and in other metropolitan areas outside of California. We believe our Wholesale Division can expand quickly into new markets with limited additional investment in infrastructure by leveraging our proprietary FastQual® system, our Web-based underwriting engine. For retail expansion, we will continue our practice of reviewing demographic information about potential markets and opening branches in markets that we believe can support a retail branch. We also plan to continue to deploy new marketing and technology initiatives and expand our product line and sales personnel in an effort to increase our existing market penetration.

Ø **Growing our portfolio of mortgage-related assets.** We intend to increase our portfolio by retaining self-originated loans through on-balance sheet securitizations. We believe this portfolio will continue

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to increase net interest income and reduce our reliance on our origination franchise to grow earnings. We expect that our capacity to originate loans will provide us with a significant volume of loans at a lower cost and with greater reliability than if we purchased our portfolio from a third party.

- Ø **Strengthening our balance sheet.** We will seek to actively strengthen our balance sheet by increasing our liquidity and capital position with the net proceeds from this offering and future offerings and by increasing available credit under our lines of credit. We believe these efforts will better protect our franchise and provide the ability to respond to disruptions in the market or other adverse conditions and to meet the REIT distribution and other qualification requirements. We have reached agreements with two of our lenders to increase the amount of financing under our lines of credit and we are negotiating with two new lenders to provide additional financing. We will also seek to enhance our cash position by retaining some or all of our earnings in our taxable REIT subsidiaries and seeking to access the capital markets through this offering and future offerings. A strong balance sheet allows us to hold loans for a longer period in the event that the secondary market for our loans weakens or becomes unstable due to temporary market disruption.
  
- Ø **Actively managing our mortgage loan portfolio.** We will seek to actively manage the interest rate and credit risks relating to holding a portfolio of mortgage-related assets in an effort to generate an attractive risk-adjusted return on our stockholders' equity. We will continue to use hedge instruments to attempt to reduce the interest rate exposure that results from financing fixed-rate assets with floating-rate liabilities. We will also actively monitor our portfolio to manage our credit exposure through early detection and management of probable delinquencies.
  
- Ø **Expanding our servicing platform.** We intend to grow our servicing portfolio, given our recent RPS3, or average, rating from Fitch and average rating from S&P. We expect to service loans owned by third parties to take advantage of our technical capabilities, capitalization and economies of scale. We believe our income from servicing will increase in a rising interest rate environment which will help to offset any decline in our origination volume.
  
- Ø **Exploring diversification strategies.** We intend to further diversify our revenues by opportunistically evaluating and executing strategic acquisitions and new business opportunities.

### **COMPETITIVE ADVANTAGES**

We believe that the following competitive strengths distinguish our business model from those of other residential mortgage lenders and REITs, and will enable us to implement our business strategy:

- Ø **Leading market presence.** We are the nation's second largest subprime mortgage finance company by market share. We provide primarily first mortgage products to borrowers nationwide. We are authorized to lend in all 50 states and have a leading market presence through a wholesale network of approximately 31,200 approved independent mortgage brokers and our retail network of 74 branch offices in 29 states.
  
- Ø **Operational flexibility.** Our structure and business strategy provide us with the flexibility to both securitize a portion of our loan originations for our portfolio and sell the balance for cash. We believe that this flexibility allows us to provide a broader product offering, better manage our cash flows and respond to the secondary market environment, thus enhancing the return on our stockholders' equity.
  
- Ø **Long-standing institutional relationships.** We have developed long-standing relationships with a variety of institutional loan buyers, including Bear Stearns, Credit Suisse First Boston, Deutsche Bank, Goldman Sachs, Morgan Stanley and UBS Real Estate Securities. These

loan buyers regularly bid on and purchase large loan pools from us and we frequently enter into committed forward loan sale agreements with them. In addition, we have developed relationships with a variety of institutional

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lenders, including Bank of America, Bear Stearns, CDC Mortgage Capital, Citigroup Global Markets, Morgan Stanley and UBS Real Estate Securities, all of whom have existing lending relationships with us.

- Ø **Lower-cost portfolio accumulation strategy.** Unlike mortgage REITs without origination capabilities, we believe our ability to originate loans through one of more of our qualified REIT subsidiaries and purchasing loans originated by one or more of our taxable REIT subsidiaries will allow us to accumulate mortgage loans at a lower cost and with greater reliability than would be available through secondary market purchases.
- Ø **Automated credit grading capability.** We have created a proprietary automated credit grading and pricing methodology that we believe, based upon our historical loan performance, gives us the ability to more effectively evaluate credit risk and more efficiently price our products. This automated credit grading system helps us construct a more consistent and predictable portfolio, which we believe enables us to generate attractive risk-adjusted returns.
- Ø **High quality customer service.** We strive to make the origination process easy for our borrowers and brokers by providing prompt responses, consistent and clear procedures, and an emphasis on ease of use through technology, including our FastQual® system.
- Ø **Management experience and depth.** The members of our senior management team have, on average, over 20 years of experience in the mortgage finance sector, with substantial experience addressing the challenges posed by a variety of interest rate environments, including growing an origination franchise, managing credit risk and developing strong capital market relationships.

## **THE RESIDENTIAL MORTGAGE MARKET**

The residential mortgage market is the largest consumer finance market in the United States. According to the MBA, lenders in the United States originated over \$3.8 trillion of single-family mortgage loans in 2003 and the MBA is predicting originations of \$2.5 trillion in 2004. The residential mortgage market can generally be bifurcated into conforming and non-conforming mortgage loans. Non-conforming mortgage loans are those mortgage loans generally not eligible for sale to Fannie Mae or Freddie Mac due to size and/or credit characteristics. Our loan production focuses on the subprime mortgage segment of the non-conforming market, which consists of loans that generally do not satisfy the credit characteristics of the conforming market.

According to Inside B&C Lending, an industry trade publication, the total size of the subprime mortgage market volume was approximately \$332 billion in 2003, which represented approximately 9% of the overall residential mortgage market. The subprime mortgage market has grown from \$34 billion in 1994 to \$332 billion in 2003, representing a 29% compounded annual growth rate, while the overall single-family residential mortgage market has grown from \$769 billion in 1994 to \$3.8 trillion in 2003, representing a compounded annual growth rate of 19%.

In addition to faster growth, the subprime mortgage market has historically focused on home purchases and cash-out refinancings, rather than interest rate driven refinancings, which have caused this market segment to be less interest rate sensitive, and therefore less volatile, than the prime mortgage market. For example, for the 10 quarters ended June 30, 2004, the prime loan origination market experienced substantial volatility with a peak quarterly growth rate of approximately 52.2% in the second quarter of 2003, and a peak quarterly decline of approximately 51.9% in the fourth quarter of 2003. In contrast, during the same period, the subprime loan origination market experienced a peak growth rate of approximately 39.2% in the second quarter of 2004, did not decline at all during that period and



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experienced the lowest quarterly increase of 1.6% in the first quarter of 2003. In addition, the subprime market has shown an ability to grow during volatile interest rate environments, as indicated by the subprime market's growth by an average of 16.7% over the three quarters ended June 30, 2004, in contrast to the prime market's decline by an average of 2.3% over these same periods.

**SECONDARY MARKETING STRATEGIES**

Following this offering, we intend to continue to structure the securitization of the loans that we retain in our loan portfolio as financings rather than sales for tax and financial reporting purposes through the use of collateralized mortgage obligations, or CMOs. Accordingly, these loans will remain on our consolidated balance sheet as an asset and the underlying bonds will be reported as a liability on our balance sheet. Thus, we will record interest income generated by the mortgage loans and recognize interest expense on the related financings over the life of the mortgage loan pool, rather than generate a gain or loss at the time of the securitization.

A substantial portion of the net interest income generated by our securitized loans will be based upon the difference between the weighted average interest earned on the mortgage loans and the interest payable to holders of the bonds collateralized by our loans. The income we receive from the securitizations structured as financings is based primarily on LIBOR. This is because the interest on the underlying mortgage loans is based on fixed rates payable on the underlying loans for the first two or three years from origination while the holders of the applicable securities are generally paid based on an adjustable LIBOR-based yield. Therefore, an increase in LIBOR reduces the net income we receive from, and the value of, these mortgage loans. In addition, the net interest income we receive from securitizations will be reduced if there are a significant amount of loan defaults or a large amount of loan prepayments, especially defaults on, or repayments of, loans with interest rates that are high relative to the rest of the asset pool. We anticipate that we will attempt to mitigate at least a portion of this net interest margin variability by purchasing Euro Dollar Futures contracts or interest rate caps.

We will record interest income on the mortgage loans and interest expense on the securities issued in the securitization over the life of the securitization, and will not recognize a gain or loss upon completion of the securitization for financial reporting purposes. This accounting treatment will more closely match the recognition of income with our actual receipt of cash payments, which we believe will provide us with more stable results of operations compared to companies that structure their securitizations as sales.

**INVESTMENT AND OPERATIONAL POLICIES OF NEW CENTURY REIT**

Our investment strategy is subject to change if and when our board of directors determines that a change in investment strategy is in the best interest of our stockholders.

**Mortgage loans**

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In general, our expected strategy is to hold a portfolio of mortgage loans primarily originated by one of our taxable REIT subsidiaries and by New Century REIT or one of its qualified REIT subsidiaries. Our mortgage loans are generally underwritten in accordance with the categories and criteria described in our underwriting guidelines. See Underwriting standards, Credit history, Collateral review, Income documentation Underwriting requirements.

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**Mortgage-backed securities**

From time to time, we may acquire and hold mortgage-backed securities collateralized by mortgage loans originated by and purchased from third parties in order to satisfy certain asset and income tests applicable to REITs. The mortgage-backed securities are expected to be backed primarily by first mortgages on one- to four-family dwellings and are expected to be either obligations of Fannie Mae, Freddie Mac or Ginnie Mae or have an S&P or Moody's rating of AAA. We have not previously acquired or held any third-party mortgage-backed securities in our investment portfolio.

If we change our investment strategy, the new strategy may entail more risk of loss than our currently anticipated investment strategy. Alternative strategies that our board of directors may elect to put in place include:

- ∅ purposefully exposing the value of our holdings to changes in interest rates or changes in the difference between short- and long-term rates;
- ∅ holding more securities that have a lower credit rating than AAA;
- ∅ holding securities backed by assets other than one- to four-family dwellings;

or some combination of the above, or other strategies that may entail a higher degree of risk. We need not seek stockholder approval nor notify stockholders prior to changing our investment strategy.

We will seek to be an opportunistic investor and will not have specific guidelines or policies dictating specific investment or operating restrictions. It is possible that we will make investments that have a high risk profile relative to the anticipated returns, which could result in losses that would harm our results of operations, financial condition and business prospects. See **Risk factors** Risks related to our business The loans we originate and hold are subprime, rather than prime, and generally have delinquency and default rates higher than prime loans, which could result in higher loan losses. We may take the following actions without the consent of our stockholders: (i) borrow money; (ii) make loans to other companies; (iii) invest in securities of other issuers for the purpose of exercising control; (iv) sell existing investments and make additional investments; and (v) repurchase or otherwise reacquire our shares. We also may issue preferred stock that has liquidation and dividend preferences over the outstanding common stock or offer securities in exchange for property. We plan to distribute an annual report, including our audited financial statements, to stockholders as required under the securities laws. We currently have no plan to underwrite the securities of other issuers.

**Leverage policy**

We employ a leverage strategy to increase our mortgage loan origination activities by securitizing existing mortgages in transactions that we believe will be treated as borrowings for accounting and tax purposes. We generally expect to borrow in excess of 10 times the amount of our consolidated equity capital, although our actual debt to equity ratio may vary from time to time depending on market conditions and other

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factors deemed relevant by our management and board of directors. In general, our credit facilities limit our debt-to-equity ratio to a level of 10 to 1. However, each of the lenders under our credit facilities disregards non-recourse financing, including the bonds underlying our on-balance sheet securitizations, in computing the leverage ratio. The leverage ratio as under our credit facilities was 9.1 to 1 as of June 30, 2004.

We expect that our mortgage loan portfolio will be financed by borrowings on our credit facilities, the issuance of asset-backed securities, and, to a lesser extent, our equity capital. We intend to structure the securitizations of the loans in our portfolio as financings for tax and accounting purposes, rather than as sales and, therefore, do not expect to recognize a gain or loss on securitizations.

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#### **Hedging policy**

In order to seek to mitigate the adverse effects resulting from interest rate increases on our residual interests, certain mortgage loans held for sale and certain mortgage loans held for investment, we utilize derivative financial instruments such as Euro Dollar Futures contracts and interest rate caps. It is not our policy to use derivatives to speculate on interest rates. These derivative instruments have an active secondary market and are intended to provide income and cash flow to offset potential reduced interest income and cash flow under certain interest rate environments. Certain of our interest rate management activities qualify for hedge accounting in accordance with Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended and interpreted. We report the derivative financial instruments and any related margin accounts on our consolidated balance sheets at their fair value. See Risk factors Risks related to our business Complying with REIT requirements may limit our ability to hedge interest rate risk effectively.

We intend to use several tools and risk management strategies to monitor and address interest rate risk. We believe that these tools will allow us to monitor and evaluate our exposure to interest rates and to manage the risk profile of our mortgage loan portfolio in response to changes in market conditions. As part of our interest rate risk management process, we may use derivative financial instruments such as Euro Dollar Futures, interest rate cap agreements, interest rate swap agreements, Treasury futures, and options on interest rates. We may also use other hedging instruments including mortgage derivative securities, as necessary. Hedging strategies also involve transaction and other costs. Because we intend to use derivative financial instruments to a greater extent than we have in the past, the aggregate costs to us of entering into contracts for these instruments are likely to be significantly higher than in the past.

We will actively monitor, and may have to limit, our asset/liability management program to assure that we do not realize hedging income, or hold hedges having a value, in excess of the amounts permitted by the REIT income and asset tests. In the case of excess hedging income, we would be required to pay a penalty tax for failure to satisfy one or both of the REIT income tests under the Internal Revenue Code if the excess is due to reasonable cause and not willful neglect. If our violation of the REIT gross income tests is due to willful neglect or if the value of our hedging positions causes us to violate one or more of the REIT asset tests, the penalty could be disqualification as a REIT. Attempting to comply with the REIT income and asset tests could leave us exposed to greater risks associated with changes in interest rates than we would otherwise want to bear. In addition, our management may elect to have us bear a level of risk that could otherwise be mitigated through hedging when our management believes, based on all relevant facts, that bearing such risk is advisable. We will engage in hedging for the sole purpose of protecting against interest rate risk and not for the purpose of speculating on changes in interest rates.

#### **Financing policy**

If our board of directors determines that additional funding is required, we may raise the additional funds through additional equity offerings, debt financings, retention of cash flow (subject to provisions in the Internal Revenue Code concerning distribution requirements and taxability of undistributed REIT taxable income) or a combination of these methods. In the event that our board of directors determines to raise additional equity capital, it has the authority, without stockholder approval, subject to applicable law and NYSE regulations, to issue additional common stock or preferred stock in any manner and on terms and for consideration it deems appropriate up to the amount of authorized stock set forth in our charter.

Borrowings may be in the form of bank borrowings, secured or unsecured, and publicly or privately placed debt instruments, purchase money obligations to the sellers of assets, long-term, tax-exempt



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bonds or other publicly or privately placed debt instruments, financing from banks, institutional investors or other lenders, and securitizations, including collateralized debt obligations, any of which indebtedness may be unsecured or may be secured by mortgages or other interests in the assets. Such indebtedness may entail recourse to all or any part of our assets or may be limited to the particular assets to which the indebtedness relates.

We will enter into collateralized borrowings only with institutions we believe are financially sound and that are rated investment grade by at least one nationally recognized statistical rating organization.

We have authority to offer our common stock or other equity or debt securities in exchange for property and to repurchase or otherwise reacquire our securities or any other securities and may engage in any of these activities in the future.

### **LOAN PRODUCTION CHANNELS**

Following this offering, we intend to continue to originate and purchase mortgage loans through two channels – our Wholesale Division and our Retail Division. Our Wholesale Division originates and purchases loans through a network of independent mortgage brokers and correspondent lenders solicited by our account executives. Our account executives provide on-site customer service to the broker to facilitate the loan's funding. In addition, the Wholesale Division originates mortgage loans through its FastQual® Web site at [www.newcentury.com](http://www.newcentury.com), where a broker can upload a loan request and receive a response generally within 12 seconds. Our Retail Division originates loans directly to the consumer through 74 retail branch offices located in 29 states and a central retail telemarketing unit that originates loans nationwide through one central office. Leads are generated through radio, direct mail, telemarketing and the Internet.

### **Our Wholesale Division**

During 2003, our wholesale loan originations and purchases totaled \$25.2 billion, or 92.0% of our total loan production. This production consisted of \$15.8 billion, or 62.7%, of cash-out refinancings, \$6.8 billion, or 27.0%, of home purchase financing, and \$2.6 billion, or 10.3%, of rate and term refinancings. Further, these loans consisted of \$17.7 billion, or 70.4%, of adjustable rate loans, and \$7.5 billion, or 29.6%, of fixed rate loans. During the first half of 2004, our wholesale loan originations and purchases totaled \$18.8 billion, or 90.8% of our total loan production. This production consisted of \$11.3 billion, or 60.1%, of cash-out refinancings, \$6.6 billion, or 35.3%, of home purchase financing, and \$874.3 million, or 4.6%, of rate and term refinancings. Further, these loans consisted of \$13.1 billion, or 69.7%, of adjustable rate loans, and \$5.7 billion, or 30.3%, of fixed rate loans.

As of June 30, 2004, our Wholesale Division operated through 26 regional operating centers located in 15 states and employed 685 account executives. As of June 30, 2004, we had approved approximately 31,200 mortgage brokers to submit loan applications to us. Of the total approved mortgage brokers, we originated loans through approximately 15,000 brokers during the first six months of 2004. During this period, our 10 largest producing brokers originated 5.8% of our wholesale production.

We have designed and implemented a detailed procedure for qualifying, approving and monitoring our network of approved mortgage brokers. We require all brokers to complete an application that requests general business information and to provide copies of all required licenses. Upon receipt of the application and supporting documentation, our Broker Services Department examines the materials for completeness and accuracy. Our Broker Services Department then independently verifies the information contained in the application through (i) a public records website to verify the validity and status of

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licenses, and (ii) the Mortgage Asset Research Institute, or MARI, which provides background information from both the public and private sectors.

To be approved, a broker must enter into our standard broker agreement with New Century Mortgage pursuant to which the broker agrees to abide by the provisions of our Policy on Fair Lending and our Brokers' Code of Conduct. Each broker also agrees to comply with applicable state and federal lending laws and agrees to submit true and accurate disclosures with regard to loan applications and loans. In addition, we employ a risk management team that regularly reviews and monitors the loans submitted by our brokers.

In wholesale loan originations, the broker's role is to identify the applicant, assist in completing the loan application form, gather necessary information and documents and serve as our liaison with the borrower through our lending process. We review and underwrite the application submitted by the broker, approve or deny the application, set the interest rate and other terms of the loan and, upon acceptance by the borrower and satisfaction of all conditions imposed by us, fund the loan. Because brokers conduct their own marketing and employ their own personnel to complete loan applications and maintain contact with borrowers, originating loans through our Wholesale Division allows us to increase loan volume without incurring the higher marketing, labor and other overhead costs associated with increased retail originations.

Mortgage brokers can submit loan applications through an account executive in one of our sales offices or through FastQual<sup>®</sup>, our Web-based loan underwriting engine, at [www.newcentury.com](http://www.newcentury.com).

In either case, the mortgage broker will forward the original loan package to the closest regional operating center where the loan is logged in for regulatory compliance purposes, underwritten and, in most cases, approved or denied within 24 hours of receipt. If approved, we issue a conditional approval to the broker with a list of specific conditions that have to be met (for example, credit verifications and independent third-party appraisals) and additional documents to be supplied prior to the funding of the loan. An account manager and the account executive work directly with the submitting mortgage broker who originated the loan to collect the requested information and to meet the underwriting conditions and other requirements. In most cases, we fund loans within 30 days from the date of our approval of an application.

FastQual<sup>®</sup> generally provides the broker with a response in less than 12 seconds. Loan information from the brokers' own loan operating systems can be automatically uploaded to FastQual<sup>®</sup>. The system provides all loan products for which the borrower qualifies, enabling brokers to offer their customers many options. Our FastQual<sup>®</sup> website enables mortgage brokers to evaluate loan scenarios for borrowers, submit loan applications, order credit reports, automatically credit grade the loan, obtain pricing and track the progress of the loan through funding.

Our Wholesale Division also purchases funded loans on an individual or flow basis from independent mortgage bankers and financial institutions known as correspondent lenders. We review an application for approval from each lender that seeks to sell us a funded loan. We analyze the mortgage banker's underwriting guidelines to ensure conformance with our guidelines. We also review their financial condition and licenses. We require each mortgage banker to enter into a purchase and sale agreement with customary representations and warranties regarding the loans the mortgage banker will sell to us. These representations and warranties are comparable to those given by us to the purchasers of our loans. Once the correspondent lender is approved, we re-underwrite each loan submitted by them.





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The following table sets forth selected information relating to loan originations and purchases through our Wholesale Division during the periods shown:

	For the Quarters Ended			
	September 30, 2003	December 31, 2003	March 31, 2004	June 30, 2004
Principal balance (in millions)	\$ 8,014.9	\$ 7,611.4	\$ 7,695.0	\$ 11,086.2
Average mortgage loan amount (in thousands)	\$ 181.7	\$ 172.7	\$ 171.6	\$ 179.3
Combined weighted average initial loan-to-value ratio	81.8%	83.9%	84.9%	84.9%
Percent of first mortgage loans	98.5%	97.9%	96.8%	95.8%
Property securing mortgage loans:				
Owner occupied	94.8%	94.4%	94.4%	94.5%
Nonowner occupied	5.2%	5.6%	5.6%	5.5%
Weighted average interest rate:				
Fixed-rate	6.78%	7.46%	7.30%	6.97%
ARMs initial rate	7.15%	7.18%	6.86%	6.79%
ARMs margin over index	5.65%	5.70%	5.48%	5.47%

**Our Retail Division**

During 2003, our Retail Division originated \$2.2 billion in loans, or 8.0% of our total loan production. This production consisted of \$1.8 billion, or 82.0%, of cash-out refinancings, \$58.5 million, or 2.7%, of home purchase financing, and \$336.7 million, or 15.3%, of rate and term refinancings. Further, these loans consisted of \$1.5 billion, or 66.3%, of adjustable rate loans, and \$740.0 million, or 33.7%, of fixed rate loans. During the first six months of 2004, our Retail Division originated \$1.9 billion in loans, or 9.2% of our total loan production. This production consisted of \$1.6 billion, or 81.9%, of cash out refinancings, \$80.7 million, or 4.2%, of home purchase financing, and \$264.4 million, or 13.9%, of rate and term refinancings. Further, these loans consisted of \$950.8 million, or 49.8%, of adjustable rate loans, and \$960.2 million, or 50.2%, of fixed rate loans. As of June 30, 2004, our Retail Division, including the central retail telemarketing unit, employed 767 retail loan officers located in three regional processing centers and 74 sales offices in 29 states.

By creating a direct relationship with the borrower, retail lending provides greater potential for repeat business and greater control over the lending process. Loan origination fees contribute to profitability and cash flow and partially offsets the higher costs of retail lending.

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The following table sets forth selected information relating to loan originations through our Retail Division during the periods shown:

	For the Quarters Ended			
	September 30, 2003	December 31, 2003	March 31, 2004	June 30, 2004
Principal balance (in millions)	\$ 623.9	\$ 640.1	\$ 741.3	\$ 1,169.6
Average mortgage loan amount (in thousands)	\$ 122.5	\$ 122.4	\$ 136.9	\$ 145.3
Combined weighted average initial loan-to-value ratio	80.4%	79.8%	80.1%	78.8%
Percent of first mortgage loans	99.4%	99.3%	99.2%	99.2%
Property securing mortgage loans:				
Owner occupied	96.9%	96.5%	96.8%	97.0%
Nonowner occupied	3.1%	3.5%	3.2%	3.0%
Weighted average interest rate:				
Fixed-rate	7.66%	7.55%	6.70%	6.48%
ARMs initial rate	7.81%	7.72%	6.85%	6.71%
ARMs margin over index	6.22%	6.22%	5.68%	5.62%

In January 2004, we merged the loan processing functions of both our Wholesale and Retail Divisions into 20 regional processing centers located in 14 states. The combination of our processing centers is expected to improve consistency and reduce our costs.

**MARKETING****Wholesale marketing**

After this offering, our Wholesale Division's marketing strategy will continue to focus on the sales efforts of its account executives and on providing prompt, consistent service to mortgage brokers and other customers. Our Wholesale Division supplements its strategy with direct mail and fax programs to brokers, advertisements in trade publications, in-house production of collateral sales material, seminar sponsorships, tradeshow attendance, periodic sales contests and its e-commerce website, [www.newcentury.com](http://www.newcentury.com).

Another marketing strategy created by our Wholesale Division is CloseMore University (CMU), an exclusive, one-day interactive workshop. CMU travels to major cities in the United States and invites mortgage brokers in those cities to participate in the workshop. The workshop includes industry specific speakers presenting on topics ranging from how to market to customers to how to process loans more efficiently. We introduce the brokers who attend the seminar to our Wholesale Division's FastQual system and provide them with training on our website. This additional marketing strategy fueled the growth of FastQual® during 2003. The CMU website address is at [www.closemoreu.com](http://www.closemoreu.com).

**Retail marketing**

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After this offering, our Retail Division's branch operations units will continue to rely primarily on targeted direct mail and outbound telemarketing to attract borrowers. Our direct mail programs are managed by a centralized staff who create a targeted mailing list for each branch market and oversee the completion of mailings by a third party mailing vendor. All calls or written inquiries from potential borrowers that result from the mailings are tracked centrally and then forwarded to a branch location and handled by branch loan officers.

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The direct mail program uses the Retail Division's website, *www.newcenturymortgage.com*, to provide information to prospective borrowers and to allow them to complete an application online. Under the Central Telemarketing Program, the telemarketing staff solicits prospective borrowers, makes a preliminary evaluation of the applicant's credit and the value of the mortgaged property and refers qualified leads to loan officers in the retail branch closest to the customer.

Our Retail Division's central retail telemarketing unit solicits prospective borrowers through a variety of direct response advertising methods, such as purchased leads from aggregators, radio advertising, direct mail, search engine placement, banner ads, e-mail campaigns and links to related websites. The central retail telemarketing unit also markets to our current customer base through direct mail and outbound telemarketing. Such solicitations, however, are not made within the first 12 months after loan origination. In addition, this unit maintains a comprehensive database of all customers with whom it has had contact and markets to these potential customers as well.

We may engage in broader retail marketing efforts in the future. Such efforts may include the development of a retail brand supported by mass media advertising.

### **UNDERWRITING STANDARDS**

The loans we originate or purchase generally do not satisfy conventional underwriting standards, such as those of Fannie Mae or Freddie Mac. Therefore, our loans are likely to have higher delinquency and foreclosure rates than portfolios of mortgage loans underwritten to conventional Fannie Mae and Freddie Mac standards.

Our underwriting guidelines take into account the applicant's credit history and capacity to repay the proposed loan as well as the secured property's value and adequacy as collateral for the loan. Each applicant completes an application that includes personal information on the applicant's liabilities, income, credit history and employment history. Based on our review of the loan application and other data from the applicant against our underwriting guidelines, we determine the loan terms, including the interest rate and maximum LTV.

### **Credit history**

Our underwriting guidelines require a credit report on each applicant from a credit reporting company. In evaluating an applicant's credit history, we utilize credit bureau risk scores, generally known as a FICO score, which is a statistical ranking of likely future credit performance developed by Fair, Isaac & Company and the three national credit data repositories—Equifax, TransUnion and Experian.

### **Collateral review**

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A qualified independent appraiser inspects and appraises each mortgage property and verifies that it is in acceptable condition. Following each appraisal, the appraiser prepares a report that includes a market value analysis based on recent sales of comparable homes in the area and, when appropriate, replacement cost analysis based on the current cost of constructing a similar home. All appraisals must conform to the Uniform Standards of Professional Appraisal Practice adopted by the Appraisal Foundation's Appraisal Standards Board and are generally on forms acceptable to Fannie Mae and Freddie Mac. Our underwriting guidelines require a review of the appraisal by one of our qualified employees or by a qualified review appraiser that we have retained. Our underwriting guidelines then require our underwriters to be satisfied that the value of the property being financed, as indicated by the appraisal, currently supports the outstanding loan balance.

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#### **Income documentation**

Our underwriting guidelines include three levels of income documentation requirements, referred to as the full documentation, limited documentation and stated income documentation programs. Under the full documentation program, we generally require applicants to submit two written forms of verification of stable income for at least 12 months. Under the limited documentation program, we generally require applicants to submit 12 consecutive monthly bank statements on their individual bank accounts. Under the stated income documentation program, an applicant may be qualified based upon monthly income as stated on the mortgage loan application if the applicant meets certain criteria. All of these documentation programs require that, with respect to any salaried employee, the applicant's employment be verified by telephone. In the case of a purchase money loan, we require verification of the source of funds, if any, to be deposited by the applicant into escrow. Under each of these programs, we review the applicant's source of income, calculate the amount of income from sources indicated on the loan application or similar documentation, review the applicant's credit history, and calculate the debt service-to-income ratio to determine the applicant's ability to repay the loan. We also review the type, use and condition of the property being financed. We use a qualifying interest rate that is equal to the initial interest rate on the loan to determine the applicant's ability to repay an adjustable-rate loan. For our interest-only product, we use a qualifying rate that is 3% higher than the initial interest rate for determining the repayment ability of applicants.

For the year ended December 31, 2003, full documentation loans as a percentage of total originations totaled \$15.8 billion, or 57.6%, limited documentation loans totaled \$1.3 billion, or 4.8%, and stated documentation loans totaled \$10.3 billion, or 37.6%. The weighted average FICO score of our borrowers for the year ended December 31, 2003 was 612.

For the six months ended June 30, 2004, full documentation loans as a percentage of total originations totaled \$10.9 billion, or 52.9%, limited documentation loans totaled \$978.2 million, or 4.7%, and stated documentation loans totaled \$8.8 billion, or 42.4%. The weighted average FICO score of our borrowers for the six months ended June 30, 2004 was 628.

#### **Underwriting requirements**

In general, the maximum loan amount for our mortgage loans is \$500,000. Our underwriting guidelines permit loans on owner-occupied, one-to-four-family residential properties to have:

Ø a LTV at origination of up to 95% with respect to non-conforming first liens; and

Ø a combined LTV at origination of up to 100% with respect to conforming and non-conforming second liens.

However, the applicability of these ratios to a particular borrower depends on the purpose of the mortgage loan, the borrower's credit history, our assessment of the borrower's repayment ability and debt service-to-income ratio, and the type and use of the property. The LTV of a mortgage loan secured by mortgaged property acquired by a borrower under a lease option purchase is determined in one of two ways. If the lease option price was set less than 12 months prior to origination, the LTV of the related mortgage loan is based on the lower of the appraised value at the time of origination of the mortgage loan and the sale price of the related mortgaged property. If the lease option price was set at least 12 months

or more prior to origination, the LTV of the related mortgage loan is based on the appraised value of the related mortgaged property at the time of origination.

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Our underwriting guidelines for first lien mortgage loans have the following categories and criteria for grading the potential likelihood that an applicant will satisfy the repayment obligations of a mortgage loan:

**SUMMARY OF PRINCIPAL UNDERWRITING GUIDELINES<sup>(1)</sup>**

	<b>AA Risk</b>	<b>A+ Risk</b>	<b>A- Risk</b>	<b>B Risk</b>	<b>C Risk</b>	<b>C- Risk</b>
Existing and prior mortgage history	No 30-day late payments within last 12 months; must have an LTV of 95% or less; no evidence of default in 3 years.	Maximum one 30-day late payment and no 60-day late payments within last 12 months; must have an LTV of 95% or less; no evidence of default in 3 years.	Maximum three 30-day late payments and no 60-day late payments within last 12 months; must have an LTV of 90% or less; no evidence of default in 3 years.	Maximum one 60-day late payment within last 12 months; must have an LTV of 85% or less; no evidence of default in 2 years.	Maximum one 90-day late payment within last 12 months; must have an LTV of 80% or less; no evidence of default in 1 year.	Maximum of two 90-day late payments and one 120-day late payment within last 12 months; must have an LTV of 70% or less; no current default.
Consumer credit	Minimum credit score of 500; LTVs over 80% have higher credit score minimums.	Minimum credit score of 500; LTVs over 80% have higher credit score minimums.	Minimum credit score of 500; LTVs over 80% have higher credit score minimums.	Minimum credit score of 500; LTVs over 80% have higher credit score minimums.	Minimum credit score of 500; LTVs over 75% have higher credit score minimums.	Minimum credit score of 500.
Bankruptcy filings	Generally, no Chapter 7 or 13 Bankruptcy discharged in last 2 years.	Generally, no Chapter 7 or 13 Bankruptcy discharged in last 2 years.	Generally, no Chapter 7 Bankruptcy discharged in the last 2 years or any Chapter 13 Bankruptcy filed in the last 2 years.	Generally, no Chapter 7 Bankruptcy discharged in last 18 months or Chapter 13 Bankruptcy filed in the last 18 months.	Generally, no Chapter 7 Bankruptcy discharged in the last year or any Chapter 13 Bankruptcy filed in the last year.	Chapter 7 discharged and Chapter 13 discharged or discharged at funding.
Total debt service-to-income ratio	50% to 55%	50% to 55%	50% to 55%	50% to 55%	55%	55%
Maximum loan-to-value ratio (LTV) <sup>(2)</sup> :						
Owner occupied	95%	95%	90%	85%	80%	70%
Single family; detached PUD, or 2-unit:						
Owner occupied	90%	90%	85%	80%	75%	65%
Condo/three-to-four unit:						
Nonowner occupied	85%	85%	80%	75%	70%	60%

(1) The letter grades applied to each risk classification reflect our internal standards and do not necessarily correspond to the classifications used by other mortgage lenders.

(2) The maximum LTV set forth in the table is for borrowers providing full documentation. The LTV is reduced 5% for stated income applications, if applicable.



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#### **Interest Only ARM Program**

For our Interest Only ARM Program, which is designed for a higher credit quality borrower, we assess the borrower's mortgage repayment history, any incidents of bankruptcy, mortgage default or major derogatory credit, and we require a minimum credit score of 660, which is substantially higher than our traditional product requirements. This program is restricted to owner-occupied properties and second homes, single units, two units, condominiums or detached PUDs with no rural or unique properties allowed. We have limitations on loan amount, LTV, income documentation type, and the amount of cash out allowed on refinances. We assign a unique 4-level grade classification based on the credit score range for the primary borrower. The borrower's debt ratio is calculated at 3% higher than the initial interest rate and the program requires verified liquid reserves. The loan term is 25 years with an option for interest only payments during the first 10 years, converting to a 15-year fully amortized ARM in years 11 through 25.

#### **Niche or special programs**

We have several programs that we have designated as niche or special programs. These programs are the Special Jumbo Product, the 80/20 Combo Product and the 100% High LTV Product. In general, all of these programs require the borrower to have an excellent mortgage history over the last 12 months. In addition to credit score minimums, these programs require a more in-depth analysis of consumer credit, and both the Special Jumbo Product and the 100% High LTV have requirements for verification of liquid reserves. Overall the minimum credit score for these products is 600, although the 80/20 Combo Product allows a minimum credit score of 580 with other restrictions and limitations. Maximum loan amounts or combined loan amounts on these products range from \$600,000 to \$1,000,000. Higher loan amounts have higher credit score minimums and are subject to other restrictions and limitations.

#### **Home Saver Program**

We had established a sub-category of our C- credit grade, which was eliminated from our program offerings in mid-2003, for borrowers subject to at least one of the following credit scenarios: (i) the borrower had an existing mortgage that was currently in foreclosure; (ii) the borrower was subject to a notice of default filing; or (iii) the borrower had a serious mortgage delinquency for more than one 120-day period in the prior 12 months or was more than 90 days late at the time of funding. This sub-category was known as our Home Saver Program. The Home Saver Program was available only to Full Documentation borrowers and permitted a maximum LTV of 65% and a maximum debt service-to-income ratio of 55%. The maximum loan amount was \$300,000 and all derogatory credit report items must have been brought current or paid with the loan proceeds. A maximum of 3% of the loan proceeds was allowed to the borrower in cash. If the borrower was in an open Chapter 13 bankruptcy, the bankruptcy must have been discharged with the proceeds of the loan. For the year ended December 31, 2003, Home Saver loans accounted for less than 1% of total loan originations and purchases. We no longer originate loans under this program.

#### **Exceptions**

The categories and criteria described in our underwriting guideline table above are guidelines only. On a case-by-case basis, we may determine that an applicant warrants an LTV exception, a debt service-to-income ratio exception, or another exception to our underwriting criteria. We may allow such an exception if the application reflects certain compensating factors such as low LTV, a maximum of one 30-day late payment

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on all mortgage loans during the last 12 months, and stable employment or ownership of the current residence. We may also allow an exception if the applicant places in escrow a down payment of at least 20% of the purchase price of the mortgage property or if the new loan reduces the applicant's monthly aggregate mortgage payment. Our automated credit grading system aids in

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identifying and managing underwriting exceptions. Certain of our loan programs and risk grade classifications limit the approval of exceptions to higher loan approval authority-levels. For 2003, our overall underwriting exception rate was 14.9% on total production of \$27.4 billion. For 2002, our overall underwriting exception rate was 18.5% on total production of \$14.2 billion.

We periodically evaluate and modify our underwriting guidelines. We also maintain separate underwriting guidelines appropriate to our non-conforming second lien mortgage loans and adopt new underwriting guidelines appropriate to new loan products we may offer.

**LOAN PRODUCTION BY BORROWER RISK CLASSIFICATION**

The following table sets forth information concerning the characteristics of our fixed-rate and adjustable-rate loan production by borrower risk classification for the periods shown:

	For the Quarters Ended			
	September 30, 2003	December 31, 2003	March 31, 2004	June 30, 2004
<b>AA Risk Grade:</b>				
Percent of total purchases and originations(1)	73.8%	70.3%	72.5%	78.0%
Combined weighted average initial loan-to-value ratio	83.4	86.4	87.2	86.4
Weighted average interest rate:				
Fixed-rate	6.7	7.4	7.2	6.9
ARMs initial rate	7.0	7.0	6.7	6.6
ARMs margin over index	5.5	5.6	5.4	5.4
<b>A+ Risk Grade:</b>				
Percent of total purchases and originations(1)	11.6%	12.0%	11.6%	9.4%
Combined weighted average initial loan-to-value ratio	79.5	80.0	81.1	80.4
Weighted average interest rate:				
Fixed-rate	7.2	7.5	7.1	6.8
ARMs initial rate	7.3	7.3	7.0	7.0
ARMs margin over index	5.9	5.9	5.6	5.6
<b>A- Risk Grade:</b>				
Percent of total purchases and originations	7.3%	8.2%	7.9%	6.2%
Combined weighted average initial loan-to-value ratio	76.7	76.9	76.0	76.9
Weighted average interest rate:				
Fixed-rate	7.5	7.8	7.3	7.0
ARMs initial rate	7.6	7.6	7.3	7.3
ARMs margin over index	6.0	6.0	5.7	5.7
<b>B Risk Grade:</b>				
Percent of total purchases and originations	4.6%	6.0%	4.4%	3.7%
Combined weighted average initial loan-to-value ratio	74.6	74.8	74.6	73.9
Weighted average interest rate:				
Fixed-rate	8.1	8.1	7.8	7.3
ARMs initial rate	8.1	8.0	7.8	7.6
ARMs margin over index	6.3	6.2	6.0	6.0
<b>C/C- Risk Grade:</b>				
Percent of total purchases and originations	2.7%	3.5%	3.6%	2.7%
Combined weighted average initial loan-to-value ratio	68.8	68.3	68.8	68.6
Weighted average interest rate:				

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Fixed-rate	9.0	8.9	8.6	7.9
ARMs initial rate	9.0	8.7	8.2	8.1
ARMs margin over index	6.6	6.6	6.5	6.5

- (1) The increase in AA production and decrease in A+ production from the first quarter to the second quarter resulted from a change in our credit risk grading. During the second quarter of 2003, we modified our underwriting criteria to expand to six credit grades, including the addition of our highest sub-prime credit grade of AA. We also modified the FICO credit score limits for each credit grade. These changes resulted in an increase in the percentage of loans in the upper most credit grades.
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The following table sets forth by state the aggregate dollar amounts (in thousands) and the percentage of all loans we originated or purchased for the periods shown:

	For the Quarters Ended							
	September 30, 2003		December 31, 2003		March 31, 2004		June 30, 2004	
California	\$ 3,702,465	42.9%	\$ 3,335,617	40.4%	\$ 3,339,117	39.6%	\$ 5,208,325	42.5%
Florida	507,009	5.9	481,261	5.8	517,468	6.1	762,768	6.2
New York	563,711	6.5	534,131	6.5	605,626	7.2	798,199	6.5
Illinois	370,026	4.3	330,935	4.0	281,687	3.3	364,339	3.0
Texas	345,883	4.0	331,002	4.0	345,135	4.1	444,571	3.6
Massachusetts	288,079	3.3	298,494	3.6	260,318	3.1	370,581	3.0
New Jersey	298,598	3.5	221,745	2.7	209,950	2.5	386,754	3.2
Michigan	233,875	2.7	224,593	2.7	213,470	2.5	261,679	2.1
Washington	188,254	2.2	234,458	2.8	263,981	3.1	332,488	2.7
Colorado	151,651	1.8	130,393	1.6	162,079	1.9	200,429	1.6
Other	1,989,257	22.9	2,128,933	25.9	2,237,525	26.6	3,125,735	25.6
<b>Total</b>	<b>\$ 8,638,808</b>	<b>100.0%</b>	<b>\$ 8,251,562</b>	<b>100.0%</b>	<b>\$ 8,436,356</b>	<b>100.0%</b>	<b>\$ 12,255,868</b>	<b>100.0%</b>

**FINANCING LOAN ORIGINATIONS**

We require access to credit facilities in order to originate and purchase mortgage loans and to hold them pending their sale or securitization.

As of June 30, 2004, we used our credit facilities totaling \$8.6 billion provided by Bank of America, Bear Stearns, CDC Mortgage Capital, Citigroup Global Markets Realty, Greenwich Capital, Morgan Stanley, and UBS Real Estate Securities to finance the actual funding of our loan originations and purchases. We also fund loans through our \$2.0 billion asset-backed commercial paper note facility established in September 2003. We then sell the loans through whole loan sales or securitizations within two to three months and pay down the financing facilities with the proceeds.

**LOAN SALES AND SECURITIZATIONS**

We conduct our secondary marketing operations through one of our subsidiaries, NC Capital Corporation. NC Capital Corporation buys loans from New Century Mortgage, generally within a week or two after origination, paying a price that approximates the loans' secondary market value. NC Capital Corporation then sells the loans through whole loan sales or securitizations. NC Capital Corporation is responsible for

determining when and through which channel to sell the loans, and bears the risks of market fluctuations in the period between purchase and sale. We expect that after the merger, New Century REIT and its qualified REIT subsidiaries may engage in non-REMIC CMO securitizations.

### **Whole loan sales**

As of December 31, 2003, whole loan sales accounted for \$20.8 billion, or 80.8% of our total secondary market transactions. The weighted average premiums received on whole loan sales during 2003 was equal to 4.18% of the original principal balance of the loans sold, including premiums received for servicing rights.

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We seek to maximize our premiums on whole loan sales by closely monitoring requirements of institutional purchasers and focusing on originating or purchasing the types of loans that meet those requirements and for which institutional purchasers tend to pay higher premiums. During the year ended December 31, 2003, we sold \$11.3 billion of loans to Morgan Stanley and \$4.4 billion of loans to Credit Suisse First Boston, which represented 54.2% and 21.1%, respectively, of total loans sold. While over three-fourths of our loans were sold to these two investors, our loans are sold through a competitive bid process which generally includes many more potential buyers.

We sell whole loans on a non-recourse basis pursuant to a purchase agreement in which we give customary representations and warranties regarding the loan characteristics and the origination process. Therefore, we may be required to repurchase or substitute loans in the event of a breach of these representations and warranties. In addition, we generally commit to repurchase or substitute a loan if a payment default occurs within the first month or two following the date the loan is funded, unless we make other arrangements with the purchaser. After the merger, our whole loan sales will be made through our taxable REIT subsidiaries.

### **Securitizations**

#### **Off-balance sheet securitizations**

In an off-balance sheet securitization, we sell a pool of loans to a trust for a cash purchase price and a certificate evidencing our residual interest ownership in the trust and the transaction is accounted for as a sale under generally accepted accounting principles. The trust raises the cash portion of the purchase price by selling senior certificates representing senior interests in the loans in the trust. Following the securitization, purchasers of senior certificates receive the principal collected, including prepayments, on the loans in the trust. In addition, they receive a portion of the interest on the loans in the trust equal to the specified investor pass-through interest rate on the principal balance. We receive the cash flows from the residual interests after payment of servicing fees, guarantor fees and other trust expenses if the specified over-collateralization requirements are met. Over-collateralization requirements are generally based on a percentage of the original or current unpaid principal balance of the loans and may be increased during the life of the transaction depending upon actual delinquency or loss experience. A NIMS transaction, through which certificates are sold that represent a portion of the spread between the coupon rate on the loans and the investor pass-through rate, may also occur concurrently with or shortly after a securitization. A NIMS transaction allows us to receive a substantial portion of the gain in cash at the closing of the NIMS transaction, rather than over the actual life of the loans.

During 2002, we completed one off-balance sheet securitization totaling \$845.5 million of mortgage loans. We did not complete any off-balance sheet securitizations during 2003. During the six months ended June 30, 2004, we completed one off-balance sheet transaction totaling \$337.1 million, related to our investment in Carrington Mortgage Credit Fund I, LP.

#### **On-balance sheet securitizations**

During the six months ended June 30, 2004, we completed two securitizations totaling \$3.5 billion, which were structured as on-balance sheet securitizations for accounting purposes under SFAS No. 140. On August 4, 2004, we completed a \$1.7 billion securitization structured as an on-balance sheet securitization, which is included in the balance of mortgage loans held for investment at June 30, 2004. During 2003, we completed five securitizations totaling \$4.9 billion, all of which were structured as on-





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balance sheet securitizations for financial reporting purposes under generally accepted accounting principles. This portfolio-based accounting treatment is designed to more closely match the recognition of income with the receipt of cash payments. Also, on-balance sheet securitizations are consistent with our strategy to generate primarily cash-based earnings rather than non-cash gain on sale revenue. Because we do not record gain on sale revenue in the period in which the on-balance sheet securitization occurs, the use of such portfolio-based accounting structures will result in lower income in the period in which the securitization occurs than would a traditional off-balance sheet securitization. However, the recognition of income as interest payments are received on the underlying mortgage loans is expected to result in higher income recognition in future periods than would an off-balance sheet securitization.

**LOAN SERVICING AND DELINQUENCIES**

**Servicing**

Loan servicing includes activities which seek to ensure that each loan in a mortgage servicing portfolio is repaid in accordance with its terms. Such activities are generally performed pursuant to servicing contracts we enter into with investors or their agents in connection with whole loan sales or securitizations. The servicing functions performed typically include: collecting and remitting loan payments, making required advances, accounting for principal and interest, holding escrow or impound funds for payment of taxes and insurance and, if applicable, contacting delinquent borrowers and supervising foreclosures and property dispositions in the event of un-remedied defaults. For performing these functions we generally receive a servicing fee of 0.50% annually of the outstanding principal balance of each loan in the mortgage servicing portfolio. The servicing fees are collected from the monthly payments made by the mortgagors. In addition, we generally receive other remuneration consisting of float benefits derived from collecting and remitting mortgage payments, as well as mortgagor-contracted fees such as late fees, reconveyance charges and, in some cases, prepayment penalties.

We conducted servicing operations from July 1998 through mid-2001 on our in-house servicing platform. In March 2001, we sold our portfolio of mortgage loan servicing rights to Ocwen Federal Bank. From March 2001 to September 2002, we contracted with Ocwen to perform sub-servicing functions for our mortgage loans held for sale. During that period, we either sold loans on a servicing-released basis or we sold the servicing rights to third parties.

In October 2002, we re-established mortgage servicing operations. As of June 30, 2004, the balance of our loan servicing portfolio was \$20.9 billion, consisting of \$9.1 billion in mortgage loans held for investment, \$4.8 billion in mortgage loans held for sale, \$6.4 billion in interim servicing, and \$0.6 billion in servicing rights owned.

Servicing rights owned are loans sold to whole loan investors for which we retained the servicing rights. Interim servicing represents loans sold to whole loan investors that we have agreed to service temporarily pending their transfer.

**Servicing operations**

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Once we originate or purchase a mortgage loan we begin the process of servicing the loan. We originated \$27.4 billion in mortgage loans during 2003, all of which were serviced by us on an interim servicing basis prior to sale or were included in one of our on-balance sheet securitizations. During 2003, we

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boarded an average of approximately 14,000 new loans per month to our servicing platform and transferred an average of 10,000 loans per month to other servicers as a result of whole loan sales. We generally intend to retain servicing rights on the mortgage loans we hold in our portfolio in the future.

During 2003, we completed several key servicing platform initiatives. Technology initiatives completed in 2003 include the deployment of a proprietary database to enhance the management of the disposition of real estate properties acquired through foreclosure, the deployment of a risk scoring model to assist in predicting and preventing delinquencies, an upgrade to our comprehensive call management and borrower contact software and the implementation of a data warehouse within the servicing division that provides loan-level data to management.

We establish early relationships with our borrowers from a servicing perspective. An introductory welcome phone call is made to each borrower following funding in order to introduce us to the borrower and verify critical loan and contact information. During the welcome call, our customer service agents verify with the customer the amount of the loan, first payment due date, the interest rate, the payment amount and customer receipt of their first billing statement. Additionally, information is provided to the borrower on how to contact us in the event they have additional questions or concerns regarding their loan.

While the vast majority of our customers make their payments in a timely manner, in the event a borrower becomes delinquent, our loan counselors and default personnel assist the borrower in finding a resolution and bringing the loan current. As a matter of course, by the 35th day of delinquency, depending on state specific timelines, but no earlier than the 32nd day of delinquency, a breach of contract notice is issued. Such notices allow the borrower the opportunity to cure the delinquency within the next 30 days in order to avoid referral to foreclosure.

Accounts that are referred to our Foreclosure Department are simultaneously referred to our Loss Mitigation Department. Various loss mitigation opportunities are explored with the borrower, including the possibility of forbearance agreements, listing the property for sale, deeds in lieu of foreclosure and full reinstatement of the loan. Loss mitigation strategies are designed to minimize the loss to both the borrower and investor and are structured, where possible, to insure that the loan performs in a manner that supports the avoidance of foreclosure, while at the same time minimizing fees and costs.

In the event that foreclosure is the only resolution available, we engage local attorneys to assist with managing the legal processes mandated by various state and local statutes. Foreclosure timelines are state and locality specific and have been programmed in our primary timeline management software and our loan servicing system. Properties for which the foreclosure sale has been completed and have exceeded their redemption periods (which are state specific) are transferred to our Real Estate Owned Department where our in-house asset managers manage the ultimate disposition of the properties. Once the properties have been vacated and are available for sale, they are listed and marketed for sale. We closely monitor the resulting sales price and overall recovery in order to minimize the loss incurred.

We intend to continue to retain servicing rights on a substantial percentage of the loans we sell in future periods. We recently obtained a rating of RPS3, or average, from Fitch, and an average rating from S&P for our servicing platform, which we believe will allow us to grow our servicing platform more rapidly.



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The following table sets forth loan performance data of the loans on our mortgage loan servicing platform at June 30, 2004 (dollars in thousands):

Pool Type	Balance	Weighted Average Coupon	FICO	Delinquency			Total
				<90 days	90+	REO	
Mortgage loans held for investment	\$ 9,146,472	6.92%	628	0.70%	0.82%	0.04%	1.57%
Mortgage loans held for sale	4,784,222	6.75	649	0.09	0.18	0.01	0.28
Interim servicing	6,391,425	6.98	618	0.33	0.17	0.00	0.50
Servicing rights owned	574,356	7.48	606	1.59	2.31	0.39	4.29
<b>Total</b>	<b>\$ 20,896,475</b>	<b>6.92%</b>	<b>629</b>	<b>0.47%</b>	<b>0.52%</b>	<b>0.03%</b>	<b>1.02%</b>

**COMPETITION**

We continue to face intense competition in the business of originating, purchasing and selling mortgage loans. Our competitors include other consumer finance companies, mortgage banking companies, commercial banks, credit unions, thrift institutions, credit card issuers and insurance finance companies. Other large financial institutions have gradually expanded their subprime lending capabilities. Many of these companies have greater access to capital at a cost lower than our cost of capital under our warehouse, aggregation, and asset-backed commercial paper facilities. Federally chartered banks and thrifts have a competitive advantage over us because the federal laws applicable to their operations can preempt some of the state and local lending laws applicable to our operations. In addition, many of these competitors have considerably greater technical and marketing resources than we have.

Competition among industry participants can take many forms, including convenience in obtaining a loan, customer service, marketing and distribution channels, amount and term of the loan, loan origination fees and interest rates. Additional competition may lower the rates we can charge borrowers, thereby potentially lowering gain on future loan sales and securitizations. In 2003, the most significant form of competition was pricing pressure among wholesale mortgage originators. Some of our competitors lowered rates and fees to preserve or expand their market share.

In addition, we may be forced to expand our operations at a pace which does not allow us to attract a sufficient number of employees with the capabilities to ensure we are in compliance with the numerous complex regulations applicable to our business as well as to enable us to provide high quality customer service and this could result in harm to our results of operations, financial condition and business prospects.

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To the extent we must purchase mortgage loans or mortgage-related assets from third parties, we must compete with other REITs, investment banking firms, savings and loan associations, banks, insurance companies, other lenders and other entities that purchase mortgage loans or mortgage-related assets, many of which have greater financial resources than we do. As a result, we may not be able to acquire sufficient mortgage-related assets at favorable spreads over our borrowing costs, which would harm our results of operations, financial condition and business prospects.

Our results of operations, financial condition and business prospects could be harmed if competition intensifies or if any of our competitors significantly expands its activities in our markets. Fluctuations in

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interest rates and general economic conditions may also affect our competitive position. During periods of rising rates, competitors that have locked in low borrowing costs may have a competitive advantage. During periods of declining rates, competitors may solicit our customers to refinance their loans.

**REGULATION**

Our business is regulated by federal, state, and local government authorities and is subject to extensive federal, state and local laws, rules and regulations. We are also subject to judicial and administrative decisions that impose requirements and restrictions on our business. At the federal-level, these laws and regulations include the:

- Ø Equal Credit Opportunity Act;
  
- Ø Federal Truth in Lending Act and Regulation Z;
  
- Ø Home Ownership and Equity Protection Act;
  
- Ø Real Estate Settlement Procedures Act;
  
- Ø Fair Credit Reporting Act;
  
- Ø Fair Debt Collection Practices Act;
  
- Ø Home Mortgage Disclosure Act;
  
- Ø Fair Housing Act;
  
- Ø Telephone Consumer Protection Act;
  
- Ø Gramm-Leach-Bliley Act;
  
- Ø Fair and Accurate Credit Transactions Act;

Ø CAN-SPAM Act;

Ø Sarbanes-Oxley Act; and

Ø USA PATRIOT Act.

These laws, rules and regulations, among other things:

Ø impose licensing obligations and financial requirements on us;

Ø limit the interest rates, finance charges, and other fees that we may charge;

Ø prohibit discrimination;

Ø impose underwriting requirements;

Ø mandate disclosures and notices to consumers;

Ø mandate the collection and reporting of statistical data regarding our customers;

Ø regulate our marketing techniques and practices;

Ø require us to safeguard non-public information about our customers;

Ø regulate our collection practices;

Ø require us to prevent money-laundering or doing business with suspected terrorists; and

Ø impose corporate governance, internal control and financial reporting obligations and standards.



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Our failure to comply with these laws can lead to:

- ∅ civil and criminal liability;
- ∅ loss of approved status;
- ∅ demands for indemnification or loan repurchases from buyers of our loans;
- ∅ class action lawsuits; and
- ∅ administrative enforcement actions.

### **COMPLIANCE, QUALITY CONTROL AND QUALITY ASSURANCE**

We regularly monitor the laws, rules and regulations that apply to our business and analyze any changes to them. We integrate many legal and regulatory requirements into our automated loan origination system to reduce the prospect of inadvertent non-compliance due to human error. We also maintain policies and procedures, summaries and checklists to help our origination personnel comply with these laws.

Our training programs are designed to teach our personnel about the significant laws, rules and regulations that affect their job responsibilities. We also maintain a variety of pre-funding quality control procedures designed to detect compliance errors prior to funding.

In addition, we also subject a statistically valid sampling of our loans to post-funding quality assurance reviews and analysis. We track the results of the quality assurance reviews and report them back to the responsible origination units. To the extent refunds or other corrective actions are appropriate, we deduct those amounts from the internal profit and loss calculation for that origination unit. Many of our managers have their compensation tied partly to the quality assurance results of their units.

Our loans and practices are also reviewed regularly in connection with the due diligence that our loan buyers and lenders perform. Our state regulators also review our practices and loan files regularly and report the results back to us. Since our inception, we have undergone over 85 state examinations. To date, the state examinations have never resulted in findings of material violations or imposition of penalties.

### **Licensing**

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As of December 31, 2003, we were licensed or exempt from licensing requirements by the relevant state banking or consumer credit agencies to originate first mortgages in all 50 states and the District of Columbia and second mortgages in 48 states and the District of Columbia. As of June 30, 2004, New Century Credit was authorized to originate mortgage loans in 4 states and we are seeking to authorize New Century Credit in the states in which it is not currently authorized to originate mortgage loans under that name; as of July 31, 2004, New Century Credit was also authorized to originate mortgage loans in 29 other states under the name of its predecessor, Worth Funding Incorporated.

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## **REGULATORY DEVELOPMENTS**

During 2003, federal and state legislators and regulators adopted a variety of new or expanded regulations, particularly in the areas of privacy and consumer protection. We summarize these regulations below.

### **Privacy**

The federal Gramm-Leach-Bliley financial reform legislation imposes additional obligations on us to safeguard the information we maintain on our borrowers. Regulations have been proposed by several agencies that may affect our obligations to safeguard information. In addition, regulations that could affect the content of our notices are being considered by several federal agencies. Also, several states are considering even more stringent privacy legislation. California has passed legislation known as the California Financial Information Privacy Act and the California On-Line Privacy Protection Act. Both pieces of legislation became effective July 1, 2004, and impose additional notification obligations on us that are not pre-empted by existing federal law. If other states choose to follow California and adopt a variety of inconsistent state privacy legislation, our compliance costs could substantially increase.

### **Fair Credit Reporting Act**

The Fair Credit Reporting Act provides federal preemption for lenders to share information with affiliates and certain third parties and to provide pre-approved offers of credit to consumers. Congress acted in late 2003 to make this preemption permanent, otherwise it would have expired at the end of the year and states could have imposed more stringent and inconsistent regulations regarding the use of pre-approved offers of credit and other information sharing. Congress also amended the Fair Credit Reporting Act to place further restrictions on the use of information shared between affiliates, to provide new disclosures to consumers when risk based pricing is used in the credit decision, and to help protect consumers from identity theft. All of these new provisions impose additional regulatory and compliance costs on us and reduce the effectiveness of our marketing programs.

### **Home Mortgage Disclosure Act**

In 2002, the Federal Reserve Board adopted changes to Regulation C promulgated under the Home Mortgage Disclosure Act. Among other things, the new regulations require lenders to report pricing data on loans with annual percentage rates that exceed the yield on treasury bills with comparable maturities by 3%. The expanded reporting takes effect in 2004 for reports filed in 2005. We anticipate that a majority of our loans would be subject to the expanded reporting requirements.

The expanded reporting does not provide for additional loan information such as credit risk, debt-to-income ratio, LTV, documentation-level or other salient loan features. As a result, lenders are concerned that the reported information may lead to increased litigation as the information could be misinterpreted by third parties.

**Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003**

The CAN-SPAM Act of 2003 applies to businesses, such as ours, that use electronic mail for advertising and solicitation. This law, generally administered by the Federal Trade Commission, preempts state laws to the contrary, and establishes, among other things, a national uniform standard that gives consumers the right to stop unwanted emails. New requirements are imposed for the header caption in emails, as well as return email addresses, and consumers are granted the right to opt out from receiving further

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emails from the sender. These new provisions impose additional regulatory and compliance costs on us and reduce the effectiveness of our marketing programs.

### **The Alternative Mortgage Transaction Parity Act**

This law was enacted to enable state chartered housing creditors, like New Century Financial, to make, purchase and enforce alternative mortgage transactions (i.e., loans that are not fixed rate, fully amortized) without regard to any state law on the subject, so long as these creditors complied with the same regulatory guidelines as federally chartered housing lenders. The OTS, under whose guidelines we operate, amended its regulations, effective July 1, 2003, to eliminate from the preemptive effect of the Act the regulation of prepayment and late charges on alternative mortgage loans. States can now regulate prepayment penalty and late charge provisions on alternative mortgage loans, and so on July 1, 2003, in less than a dozen states, we became subject to more restrictive state laws as to these issues.

### **Telephone Consumer Protection Act and Telemarketing Consumer Fraud and Abuse Prevention Act**

These laws, enacted in 1991 and 1994, respectively, are designed to restrict unsolicited advertising using the telephone and facsimile machine. Since they were enacted, however, telemarketing practices have changed significantly due to new technologies that make it easier to target potential customers while at the same time making it more cost effective to do so. The Federal Communications Commission and the Federal Trade Commission have responsibility for regulating various aspects of these laws, such as regulating unwanted telephone solicitations and the use of automated telephone dialing systems, prerecorded or artificial voice messages, and telephone facsimile machines. In 2003, both agencies adopted do-not-call registry requirements, which, in part, mandate that companies such as us maintain and regularly update lists of consumers who have chosen not to be called. These requirements also mandate that we do not call consumers who have chosen to be on the list. During this same time, over 25 states have also adopted similar laws, with which we also comply. As with other regulatory requirements, these provisions impose additional regulatory and compliance costs on us and reduce the effectiveness of our marketing programs.

### **Predatory lending legislation**

The Home Ownership and Equity Protection Act of 1994, or HOEPA, identifies a category of mortgage loans and subjects them to more stringent restrictions and disclosure requirements. In addition, liability for violations of applicable law for loans covered by HOEPA extends not only to the originator, but also to the purchaser of the loans. HOEPA generally covers loans with either (i) total points and fees upon origination in excess of the greater of eight percent of the loan amount or \$499 (an annually adjusted dollar amount), or (ii) an APR of more than eight percentage points higher than United States Treasury securities of comparable maturity on first mortgage loans, and 10 percentage points above Treasuries of comparable maturity for junior mortgage loans.

We do not originate loans covered by HOEPA because of the higher legal risks as well as the potential negative perception of originating loans that are considered to be high cost under federal law.

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Several federal, state and local laws and regulations have been adopted or are under consideration that are intended to eliminate so-called predatory lending practices. Many of these laws and regulations go beyond targeting abusive practices by imposing broad restrictions on certain commonly accepted lending practices, including some of our practices. In addition, some of these laws impose liability on assignees of

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mortgage loans such as loan buyers, lenders and securitization trusts. Such provisions deter loan buyers from purchasing loans covered by the applicable law. For example, the Georgia Fair Lending Act that took effect in October 2002 resulted in our withdrawal from the Georgia market, until the law was amended in early 2003, because our lenders and loan buyers refused to finance or purchase loans covered by that law. The recent enactment of similar laws late in 2003 in New Jersey and New Mexico has resulted in significant interruption in the secondary market, with some participants no longer purchasing home loans originated in those states, and some not purchasing just those loans covered by these new laws. We have eliminated making loans that are deemed high cost under these laws, and remain able to finance or sell those loans we do make.

However, there can be no assurance that other similar laws, rules or regulations, will not be adopted in the future. Adoption of these laws and regulations could have a material adverse impact on our business by substantially increasing the costs of compliance with a variety of inconsistent federal, state and local rules, or by restricting our ability to charge rates and fees adequate to compensate us for the risk associated with certain loans. Adoption of these laws could also have a material adverse effect on our loan origination volume, especially if our lenders and secondary market buyers elect not to finance or purchase loans covered by the new laws.

### **EFFORTS TO AVOID ABUSIVE LENDING PRACTICES**

In an effort to prevent the origination of loans containing unfair terms or involving predatory practices, we have adopted many policies and procedures, including the following:

#### **Product policies**

- ∅ We do not fund or purchase high cost loans as defined by HOEPA.
- ∅ We do not make or purchase loans containing single premium credit life, disability or accident insurance.
- ∅ We do not make or purchase loans containing balloon payments, negative amortization, mandatory arbitration clauses or interest rate increases triggered by borrower default.
- ∅ We offer loans with and without prepayment penalties. When a borrower opts for a loan with a prepayment charge, the borrower benefits from a lower interest rate or pays lower upfront fees.
- ∅ Our prepayment penalties do not extend beyond three years from the origination date. On fixed rate loans, the maximum prepayment penalty term is three years. Prepayment penalties on adjustable rate loans do not extend beyond the first adjustment date.
- ∅ We do not originate loans that pay off zero interest rate mortgages provided by charitable organizations or the government without borrower third-party counseling.

**Loan processing policies**

- Ø We only approve loan applications that evidence a borrower's ability to repay the loan.
  
  - Ø We consider whether the loan terms are in the borrower's best interests and document our belief that the loan represents a tangible benefit to the borrower.
  
  - Ø We do not solicit any borrowers within 12 months of loan origination.
  
  - Ø We price loans commensurate with risk.
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- Ø We use an electronic credit grading system to help ensure consistency of grading.
  
- Ø We do not ask appraisers to report a predetermined value or withhold disclosure of adverse features. Appraisers are paid for their work regardless of whether or not the loans are closed.
  
- Ø We employ electronic and manual systems to protect against adverse practices like property flipping. Loan origination systems are designed to detect red flags such as inflated appraisal values, unusual multiple borrower activity or rapid loan turnover.

**Customer interaction and education**

- Ø We market our loans with a view to encouraging a wide range of applicants strongly representative of racial, ethnic and economic diversity of the markets we serve throughout the nation.
  
- Ø We provide a helpful, easy-to-follow brochure to all our loan applicants to educate them on the loan origination process, explain basic loan terms, help them obtain a loan that suits their needs and advise them on how to find a HUD-approved loan counselor.
  
- Ø We distribute our Fair Lending Policy to all newly hired employees and hold them accountable for treating borrowers fairly and equally.
  
- Ø We provide fair lending training to employees having direct contact with borrowers or loan decision-making authority.
  
- Ø We require brokers to sign an agreement indicating that they are knowledgeable about and will abide by fair lending laws and our Broker Code of Conduct.
  
- Ø We monitor broker performance and strive to hold brokers accountable for fair and equal treatment of borrowers.
  
- Ø Our Retail Division conducts regular customer satisfaction surveys of all newly funded loans.
  
- Ø We also conduct periodic randomly selected satisfaction surveys of customers who receive loans through a mortgage broker.
  
- Ø A network of well-trained consumer relations staff in each division is dedicated to resolving consumer complaints in a timely and fair manner.
  
- Ø Our Loan Servicing Department contacts each borrower prior to the first payment to confirm that the borrower understands the loan terms.
  
- Ø When appropriate, we also offer loss mitigation counseling to borrowers in default and provide opportunities to enter into mutually acceptable reasonable repayment plans.

Ø We report borrower monthly payment performance to major credit repositories.

**Evaluation and compliance**

Ø We subject a significant statistical sampling of our loans to a rigorous quality assurance of borrower qualification, validity of information, and verified property value determination.

Ø Our Fair Lending Officer provides an independent means of reporting or discussing fair lending concerns through consumer and employee hotlines.

Ø Our Fair Lending Officer monitors production fair lending performance, including loan file analysis and reporting, and coordinates community outreach programs.

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- Ø We engage independent firms to review internal controls and operations to help ensure compliance with accepted federal and state lending regulations and practices.
  
- Ø We adhere to high origination standards in order to sell our loan products in the secondary mortgage market.
  
- Ø We treat all customer information as confidential and consider it to be nonpublic information. We maintain systems and procedures to ensure that access to nonpublic consumer information is granted only to legitimate and valid users.
  
- Ø We believe that our commitment to responsible lending is good business.
  
- Ø We strive to promote highly ethical standards throughout our industry.

We plan to continue to review, revise and improve our practices to enhance our fair lending efforts and support the goal of eliminating predatory lending practices in the industry.

### **EMPLOYEES**

At June 30, 2004, we employed approximately 4,600 employees. None of our employees is subject to a collective bargaining agreement. We believe that our relations with our employees are satisfactory.

### **PROPERTIES**

Our executive, administrative and some of our lending offices are located in Irvine, California and consist of approximately 337,000 square feet. The four leases covering the executive, administrative and lending offices expire from October 2005 to August 2008 and the combined monthly rent is \$566,105. We lease space for our regional operating centers in Bellevue, Washington; Foxborough and Woburn, Massachusetts; Bloomington, Minnesota; Greenwood Village, Colorado; Scottsdale, Arizona; Reston, Virginia; Philadelphia, Pennsylvania; Hurst and Plano, Texas; Columbus, Ohio; Honolulu, Hawaii; Itasca and Schaumburg, Illinois; Indianapolis, Indiana; Pearl River and Melville, New York; Campbell, Woodland Hills, Sacramento and San Ramon, California; and Tampa and Miami Lakes, Florida. As of June 30, 2004, these facilities had a monthly aggregate base rental of approximately \$424,000. We also lease space for our sales offices, which range in size from 350 to 3,736 square feet with lease terms typically ranging from one to five years. As of June 30, 2004, annual base rents for the sales offices ranged from approximately \$20,600 to \$101,000. In general, the terms of these leases expire between August 2004 and August 2009. We are currently in negotiations to either relocate or renew 13 office leases expiring between September 2004 and December 2004.

### **ENVIRONMENTAL**

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In the course of our business, we may acquire properties securing loans that are in default. There is a risk that hazardous or toxic waste could be found on such properties. If this occurs, we could be held responsible under applicable law for the cost of cleaning up or removing the hazardous waste. This cost could exceed the value of the underlying properties.

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**LEGAL PROCEEDINGS**

**Barney.** In December 2001, Sandra Barney filed a class action complaint against New Century Mortgage in the Circuit Court in Cook County, Illinois. The complaint alleges the unauthorized practice of law and violation of the Illinois Consumer Fraud Act for performing document preparation services for a fee by non-lawyers, and seeks to recover the fees charged for the document preparation, compensatory and punitive damages, attorneys' fees and costs. We filed a motion to dismiss in February 2002. The court thereafter consolidated our case with other similar cases filed against other lenders. In August 2002, the court ordered plaintiffs in all the consolidated cases to dismiss their cases with prejudice. Our individual plaintiff filed her notice of appeal in September 2002 and the appeal was then consolidated with 36 similar cases (Jenkins case). Appellate argument was heard on December 2, 2003. The appellate court affirmed the dismissal of the consolidated cases on December 31, 2003. The plaintiff then timely filed a petition for leave to appeal the appellate court's decision. Our response to the petition was filed in February 2004. The Illinois Supreme Court granted leave to appeal the consolidated cases, and consolidated the Jenkins case with a similar appellate action also proceeding in Illinois (King case). The plaintiffs/appellants filed their opening brief in April 2004. We filed our consolidated response brief in July 2004. The plaintiffs/appellants filed their reply brief and oral argument is scheduled to occur on September 28, 2004.

**Bernstein.** In April 2002, Paul Bernstein filed a class action complaint against New Century Mortgage in the Circuit Court of Cook County, Chicago, Illinois seeking damages for receiving unsolicited advertisements to telephone facsimile machines in violation of the Telephone Consumer Protection Act, 47 U.S.C. §227, and the Illinois Consumer Fraud Act. The plaintiffs filed an amended complaint on May 1, 2003 and on September 18, 2003 the judge granted New Century Mortgage's motion to dismiss with respect to the Illinois Consumer Fraud Act and permitted the plaintiff to replead on an individual, not consolidated, basis. On September 30, 2003, the plaintiff filed a motion for class certification and second amended complaint. The court has consolidated similar cases into three groups. We sought and obtained an order permitting us to join other defendants in this consolidated action and file a motion to dismiss the second amended complaint. Oral argument on our consolidated motion was heard on March 30, 2004. The judge dismissed the Illinois Consumer Fraud count. At the class certification hearing on August 10, 2004, the plaintiffs' motion for class certification was withdrawn and the parties agreed to a settlement in principle. Pursuant to the settlement, the plaintiffs filed a third amended complaint seeking a nationwide class. We do not believe the settlement will have a material impact on our financial position. Our insurance carriers have agreed to defend us with a reservation of rights.

**Overman.** In September 2002, Robert E. Overman and Martin Lemp filed a class action complaint in the Superior Court for Alameda County, California, against New Century Financial, New Century Mortgage, U.S. Bancorp, Loan Management Services, Inc., and certain individuals affiliated with Loan Management Services. The complaint alleges violations of the California Consumers Legal Remedies Act, Unfair, Unlawful and Deceptive Business and Advertising Practices in violation of Business & Professions Code §§17200 and 17500, Fraud-Misrepresentation and Concealment and Constructive Trust/Breach of Fiduciary Duty and damages including restitution, compensatory and punitive damages, and attorneys' fees and costs. The plaintiffs filed an amended complaint in July 2003 and in September 2003 the judge granted our demurrer challenging their claims in part. The Consumers Legal Remedies claim was dismissed and the plaintiffs withdrew the Constructive Trust/Breach of Fiduciary Duty claim. We filed our answer to the plaintiffs' amended complaint in September 2003. We then filed a \$128.7 sanctions motion seeking dismissal of the case. On December 8, 2003, the court granted the motion for sanctions against the plaintiffs for filing a first amended complaint whose allegations against New Century Financial and New Century Mortgage were devoid of evidentiary support and ordered all those claims stricken without prejudice. On January 27, 2004, the court entered a judgment of dismissal without

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prejudice in our favor. The plaintiffs filed a notice of appeal on February 20, 2004 from the judgment entered in our favor and the order granting our motion for sanctions. The plaintiffs also filed a motion with the appellate court to consolidate this appeal with three additional appeals they have sought in similar cases against other lenders. On May 28, 2004, the court denied the motion. The plaintiffs/appellants filed their opening brief on July 12, 2004. The parties stipulated to extend the due date for New Century Financial's response brief to October 8, 2004.

**England.** In April 2003, we were served with a complaint seeking class action status filed by two former, short-term employees, Kimberly A. England and Gregory M. Foshee, against New Century Financial, New Century Mortgage, Worth Funding Incorporated (now known as New Century Credit) and The Anyloan Company. The action was removed on May 12, 2003 from the 19th Judicial District Court, Parish of East Baton Rouge, State of Louisiana to the U.S. District Court for the Middle District of Louisiana in response to our Petition for Removal. The complaint alleges failure to pay overtime wages in violation of the federal Fair Labor Standards Act. The plaintiffs filed an additional action in Louisiana state court (19th Judicial District Court, Parish of East Baton Rouge) on September 18, 2003, adding James Gray as a plaintiff and seeking unpaid wages under state law, with no class claims. This second action was removed on October 3, 2003 to the U.S. District Court for the Middle District of Louisiana, and was ordered consolidated with the first action. In April 2004, the U.S. District Court unilaterally de-consolidated the James Gray individual action. In September 2003, the plaintiffs also filed a motion to dismiss their claims in Louisiana to enable them to join in a subsequently filed case in Minnesota entitled *Klas vs. New Century Financial, et al.* We opposed the motion and the court agreed with our position and refused to dismiss the plaintiffs' case, as it was filed first. The *Klas* case has now been consolidated with this case and discovery is proceeding. We filed a motion to dismiss Worth Funding Incorporated (now known as New Century Credit) and The Anyloan Company as defendants. The court granted our motion to dismiss in April 2004. On June 28, 2004, we filed a motion to reject conditional certification of a collective action. We await a ruling.

**Ines & Marquez.** In October 2003, New Century Mortgage was served with a complaint filed by Canales Jose Ines and Maria S. Marquez seeking class action status filed in the U.S. District Court, Northern District of Illinois. The complaint also named the broker, title company and related parties as defendants: Tamayo Financial Title, Inc., Presidential Title, Inc., Juan Tamayo Jr., Jose Tamayo and Luis Tamayo. The complaint alleged violations of the TILA related to the fees charged for title insurance and recording fees. We filed our motion to dismiss in December 2003 and the motion was fully briefed in January 2004. On April 5, 2004, the court granted our motion to dismiss and directed the clerk of the court to enter judgment in our favor and terminate the case from the court's docket. On April 13, 2004, the plaintiffs filed a motion for reconsideration and for leave to amend their complaint. The motion was fully briefed in June 2004. On July 20, 2004, the court denied the plaintiffs' motion for reconsideration and the plaintiff's motion for leave to amend.

**Wade.** In October 2003, New Century Mortgage was served with a complaint filed by Denise Wade seeking class action status filed in the U.S. District Court, Northern District of Illinois. The complaint was filed by the same attorney as the *Ines* case and named the broker, title company, and current servicer: Providential Bancorp, Ltd., Jet Title Services, LLC, and Ocwen Federal Bank, FSB. The complaint similarly alleges violations of the TILA related to the fees charged for title insurance and recording fees. We filed our motion to dismiss in November 2003 and the motion was fully briefed in January 2004. The plaintiff filed a motion to amend in April 2004 and it was fully briefed in June 2004. We await a ruling on both motions. On September 20, 2004, the plaintiff filed a motion for class certification. Discovery as to the individual plaintiff is proceeding.

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**Lum.** In December 2003, New Century Mortgage was served with a class action complaint filed by Elaine Lum in the state court in Suffolk County, New York. The complaint alleged that certain payments New Century Mortgage makes to mortgage brokers, sometimes referred to as yield spread premiums, interfered with the contractual relationship between Ms. Lum and her broker. The complaint also sought damages related thereto for fraud, wrongful inducement/breach of fiduciary duty, violation of deceptive acts and practices, unjust enrichment and commercial bribing. The complaint seeks class certification for similarly situated borrowers in the State of New York. We filed a motion to dismiss on January 30, 2004. The judge granted our motion and dismissed all claims on March 23, 2004. On April 12, 2004, the plaintiff filed a notice of appeal, seeking review of the court's order granting our motion to dismiss.

**Warburton.** In June 2004, New Century Financial and New Century Mortgage were named as defendants and served with a class action complaint filed by Joseph and Emma Warburton, as plaintiffs, in the United States District Court of New Jersey. The complaint alleges violations of the Real Estate Settlement Procedures Act, the TILA and the New Jersey Consumer Fraud Act, and unjust enrichment. The complaint also alleges certain other violations against defendants unrelated to New Century Financial and New Century Mortgage, including Foxtons, Inc., Foxtons North America, Foxtons Realtor and Foxtons Financial, Inc., which we refer to collectively as Foxtons, and Worldwide Financial Resources, Inc. The plaintiffs allege, among other things, that Foxtons, acting as their broker, charged fees and received a yield spread premium without disclosing the same to them until the time of closing. The class is defined as all persons in the state of New Jersey who have purchased, or sought to purchase, a home listed for sale by Foxtons and who have paid a prequalification application fee, or who have received and accepted an offer from Foxtons for a fixed interest rate mortgage loan that Foxtons failed to deliver as promised and who have suffered damages as a result. The complaint seeks to enjoin the wrongful conduct alleged, recovery of actual and statutory damages, and attorneys' fees and costs. The complaint does not specify the amount of damages sought. On July 28, 2004, we filed a motion to dismiss the complaint for failure to state a claim. We await a ruling.

**Randall.** In June 2004, New Century Mortgage was named as a defendant and served with a class action complaint filed by Kristi Lyn Randall, as plaintiff, in the Circuit Court of Cook County, Illinois. The complaint alleges that New Century Mortgage violated Section 4.1a of the Illinois Interest Act by charging more than 3 points on loans with an interest rate of 8% per annum or higher. The complaint also alleges that New Century Mortgage and defendant Nations Title Agency of Illinois, Inc. violated state law by improperly charging certain fees and taxes. The class is defined as all persons who are residents of Illinois who obtained loans from New Century Mortgage (which loans are still outstanding or were paid off within two years prior to the filing of this action) at an interest rate of 8% per annum or higher and were charged more than 3 points on such loans. The complaint seeks recovery of statutory, compensatory, punitive and restitutionary damages, and attorneys' fees and costs. The complaint does not specify the amount of damages sought. The plaintiff was granted leave to file an amended complaint on July 21, 2004, which adds Robert and Alice Elibasich as plaintiffs. We filed our answer in August 2004. On August 4, 2004, the plaintiffs filed a motion for immediate class certification and the judge denied the request for immediate relief and set a briefing schedule for class certification. The motion for class certification has been stayed per the Court's order of September 16, 2004. Discovery is proceeding.

**DOL investigation.** On August 2, 2004, the U.S. Department of Labor, Wage & Hour Division, or DOL, informed us that it is conducting an investigation to determine whether we are in compliance with the Fair Labor Standards Act, or FLSA. The DOL has narrowed the scope of its investigation. We believe we are in compliance with the FLSA and that we properly pay overtime wages.

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We are also a party to various legal proceedings arising out of the ordinary course of our business. Management believes that any liability with respect to these legal actions, individually or in the aggregate, will not have a material adverse effect on our business, results of operation or financial position.

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## Management

The following table sets forth information about our executive officers and directors as of July 28, 2004:

<u>Name</u>	<u>Age</u>	<u>Position</u>
Robert K. Cole	57	Chairman of the Board of Directors and Chief Executive Officer of New Century REIT; Chairman of the Board of Directors and Chief Executive Officer of New Century Financial; Director of New Century Mortgage <sup>(1)</sup>
Brad A. Morrice	48	Vice Chairman of the Board of Directors, President and Chief Operating Officer of New Century REIT; Vice Chairman of the Board of Directors, President and Chief Operating Officer of New Century Financial; Chairman of the Board of Directors and Chief Executive Officer of New Century Mortgage <sup>(1)</sup> ; Chairman of the Board of Directors of NC Capital Corporation <sup>(2)</sup>
Edward F. Gotschall	49	Vice Chairman-Finance of the Board of Directors of New Century REIT; Vice Chairman-Finance of the Board of Directors of New Century Financial; Executive Vice President and Director of New Century Mortgage <sup>(1)</sup> ; Chief Financial Officer and Director of NC Capital <sup>(2)</sup>
Patti M. Dodge	43	Chief Financial Officer, Executive Vice President and Controller of New Century REIT; Chief Financial Officer, Executive Vice President and Controller of New Century Financial; Chief Financial Officer and Executive Vice President of New Century Mortgage <sup>(1)</sup>
Patrick J. Flanagan	39	Executive Vice President of New Century REIT; Executive Vice President of New Century Financial; President and Director of New Century Mortgage <sup>(1)</sup> ; Chief Executive Officer and Director of NC Capital <sup>(2)</sup>
Patrick H. Rank	59	Executive Vice President of New Century REIT; Executive Vice President of New Century Financial
Harold A. Black	59	Director
Fredric J. Forster	60	Director
Donald E. Lange	59	Director
William J. Popejoy	66	Director
Michael M. Sachs	63	Director
Terrence P. Sandvik	65	Director
Richard A. Zona	59	Director

(1) New Century Mortgage is a wholly-owned subsidiary of New Century Financial.

(2) NC Capital Corporation is a wholly-owned subsidiary of New Century Mortgage.

**Robert K. Cole** is currently the Chairman of the Board of Directors and Chief Executive Officer of New Century REIT and will continue in such capacities following completion of the merger. He is one of the co-founders, and has been the Chairman of the Board of Directors and Chief Executive Officer of New Century Financial since December 1995, and will continue in such capacities following completion of the merger. Mr. Cole also serves as a director of New Century Mortgage. From February 1994 to March 1995, he was the President and Chief Operating Officer-Finance of Plaza Home Mortgage Corporation, a publicly-traded savings and loan holding company specializing in the

origination and servicing of residential mortgage loans. In addition, Mr. Cole served as a director of Option One Mortgage Corporation, a

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**Management**

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subsidiary of Plaza Home Mortgage specializing in the origination, sale and servicing of non-prime mortgage loans. Previously, Mr. Cole was the President of operating subsidiaries of NBD Bancorp and Public Storage, Inc. Mr. Cole received a Masters of Business Administration degree from Wayne State University.

**Brad A. Morrice** is currently a Vice Chairman of the Board of Directors and President and Chief Operating Officer of New Century REIT and will continue in such capacities following completion of the merger. He is one of the co-founders, and has been a Vice Chairman of the Board of Directors of New Century Financial since December 1996, its President and one of its directors since November 1995 and its Chief Operating Officer since January 2001. Following completion of the merger, Mr. Morrice will be President and a director of New Century Financial. Mr. Morrice also served as the General Counsel of New Century Financial from December 1995 to December 1997 and its Secretary from December 1995 to May 1999. In addition, Mr. Morrice serves as Chairman of the Board of Directors and Chief Executive Officer of New Century Mortgage, Chairman of the Board of Directors of NC Capital and from 1999 to December 2003 was Chairman of the Board of Directors of The Anyloan Company. From February 1994 to March 1995, he was the President and Chief Operating Officer-Administration of Plaza Home Mortgage, after serving as its Executive Vice President, Chief Administrative Officer since February 1993. In addition, Mr. Morrice served as General Counsel and a director of Option One. From August 1990 to January 1993, Mr. Morrice was a partner in the law firm of King, Purtich & Morrice, where he specialized in the legal representation of mortgage banking companies. Mr. Morrice previously practiced law at the firms of Fried, King, Holmes & August and Manatt, Phelps & Phillips. He received his law degree from the University of California, Berkeley (Boalt Hall) and a Masters of Business Administration degree from Stanford University.

**Edward F. Gotschall** is currently the Vice Chairman-Finance of the Board of Directors of New Century REIT and will continue in such capacity following completion of the merger. He is one of the co-founders of New Century Financial, and has been the Vice Chairman-Finance of the Board of Directors of New Century Financial since July 16, 2004, a Vice Chairman of its Board of Directors from December 1996 to July 2004, its Chief Financial Officer from August 1998 to July 2004, its Chief Operating Officer Finance/Administration from December 1995 to August 1998 and one of its directors since November 1995. Following the completion of the merger, Mr. Gotschall will be the Vice Chairman-Finance and a director of New Century Financial. Mr. Gotschall also serves as Executive Vice President and a director of New Century Mortgage and was its Chief Financial Officer until February 2002. Mr. Gotschall is also Chief Financial Officer and a director of NC Capital and from 1999 to December 2003 was Chief Financial Officer and Treasurer of The Anyloan Company. From April 1994 to July 1995, he was the Executive Vice President/Chief Financial Officer of Plaza Home Mortgage and a director of Option One. In December 1992, Mr. Gotschall was one of the co-founders of Option One and served as its Executive Vice President/Chief Financial Officer until April 1994. From January 1991 to July 1992, he was the Executive Vice President/Chief Financial Officer of The Mortgage Network, Inc., a retail mortgage banking company. Mr. Gotschall received his Bachelors of Science Degree in Business Administration from Arizona State University.

**Patti M. Dodge** is currently the Chief Financial Officer, an Executive Vice President and the Controller of New Century REIT and will continue in such capacities following completion of the merger. She is also the Chief Financial Officer, an Executive Vice President and the Controller of New Century Financial and will continue in such capacities following the completion of the merger. Ms. Dodge has served as the Chief Financial Officer of New Century Financial since July 16, 2004, as an Executive Vice President of New Century Financial since March 2004 and as the Controller of New Century Financial since September 1996. She is also an Executive Vice President and the Chief Financial Officer of New Century Mortgage. She has served as an Executive Vice President of New Century Mortgage since March 2004

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and as the Chief Financial Officer of New Century Mortgage since February 2002. Between September 1996 and February 2002, Ms. Dodge served as the Vice President and Controller of New Century Mortgage. Ms. Dodge received her bachelor's degree in business administration with an emphasis in accounting from the University of Southern California in Los Angeles, California.

**Patrick J. Flanagan** is currently an Executive Vice President of New Century REIT and will continue in such capacity following completion of the merger. He has been the President of New Century Mortgage since February 2002 and has been a director of New Century Mortgage since May 1997. He has also served as Executive Vice President of New Century Financial since August 1998 and will continue in such capacity following completion of the merger, and is Chief Executive Officer and a director of NC Capital. From January 1997 to February 2002, Mr. Flanagan served as Executive Vice President and Chief Operating Officer of New Century Mortgage. Mr. Flanagan initially joined New Century Mortgage in May 1996 as Regional Vice President of Midwest Wholesale and Retail Operations. From August 1994 to April 1996, Mr. Flanagan was a Regional Manager with Long Beach Mortgage. From July 1992 to July 1994, he was an Assistant Vice President for First Chicago Bank, from February 1989 to February 1991, he was Assistant Vice President for Banc One in Chicago, and from February 1991 to July 1992, he was a Business Development Manager for Transamerica Financial Services. Mr. Flanagan received his Bachelor of Arts degree from Monmouth College.

**Patrick H. Rank** is currently an Executive Vice President of New Century REIT and will continue in such capacity following completion of the merger. He has been an Executive Vice President of New Century Financial since May 2002 and will continue in such capacity following completion of the merger. Mr. Rank has also been a director of New Century Mortgage since May 2002. He served as President of Retail Operations of New Century Mortgage from August 2001 to December 2003. He was also President, Chief Executive Officer and a director of The Anyloan Company from August 2001 to December 2003. Prior to joining New Century, Mr. Rank was the President of H&R Block Mortgage, a subsidiary of Option One Mortgage, and H&R Block Financial Services. Mr. Rank was one of the original co-founders of Option One Mortgage and was its original Chief Executive Officer. Prior to joining Option One, Mr. Rank was the Chief Administrative Officer of Long Beach Mortgage. Mr. Rank has over 36 years of financial services industry experience.

**Harold A. Black** is currently a director of New Century REIT and will continue in such capacity following completion of the merger. Dr. Black has been a director of New Century Financial since June 2004, but will not continue in such capacity following completion of the merger. Dr. Black has served as the James F. Smith, Jr. Professor of Financial Institutions at the University of Tennessee, Knoxville since 1987. From 1987 to 1995, he was Head, Department of Finance, College of Business Administration of the University of Tennessee. Prior to joining the faculty at the University of Tennessee, Knoxville, Dr. Black served on the faculties of American University, Howard University, the University of North Carolina - Chapel Hill and the University of Florida. His government service includes being Deputy Director, Department of Economic Research and Analysis, Office of the Comptroller of the Currency from 1976 to 1978 and board member of the National Credit Union Administration from 1979 to 1981. Dr. Black served as a director from 1990 to 1994, and Chairman in 1992, of the Nashville Branch of the Federal Reserve Bank of Atlanta, as a public interest member of the Federal Deposit Insurance Corporation's Savings Association Insurance Fund Advisory Committee from 1994 to 1998 and as a director of H.F. Ahmanson & Co., the parent company of Home Savings of America prior to its merger with Washington Mutual Savings Bank, from 1995 to 1998. Dr. Black received his undergraduate degree from the University of Georgia and his M.A. and Ph.D. degrees from the Ohio State University.

**Fredric J. Forster** is currently a director of New Century REIT and will continue in such capacity following completion of the merger. Mr. Forster has been one of the directors of New Century Financial since 1997, but will not continue in such capacity following completion of the merger. Mr. Forster has



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been a private investor and business consultant since January 1998. From March 1999 to May 2001, Mr. Forster was a director of and consultant to LoanTrader, a private company that developed a website serving mortgage brokers and lenders. Previously, Mr. Forster was a Principal of Financial Institutional Partners from November 1996 until December 1998. Prior to that, he served as President and Chief Operating Officer of H.F. Ahmanson and Company, and its subsidiary, Home Savings of America.

**Donald E. Lange** is currently a director of New Century REIT and will continue in such capacity following completion of the merger. Mr. Lange has been one of the directors of New Century Financial since 2002, but will not continue in such capacity following completion of the merger. He has served as the President and Chief Executive Officer of Pacific Financial Services, a mortgage banking and specialty finance company, since 1999. From March 2001 to February 2002, Mr. Lange served as President and Chief Executive Officer of OptiFI, a private company specializing in prepayment analytics. Previously, he served as the President and Chief Executive Officer of several specialty finance subsidiaries of Weyerhaeuser Company, including Weyerhaeuser Financial Services, Weyerhaeuser Mortgage Company and Weyerhaeuser Venture Company. Mr. Lange served as a director of Mortgage Electronic Registration System (MERS) from 1995 until 2002. In addition, he was a director of Pacific Gulf Properties from 1998 until 2001 and a director of Pedestal from 1999 until 2001. Mr. Lange was the President of the Mortgage Bankers Association of America in 1999.

**William J. Popejoy** is currently a director of New Century REIT and will continue in such capacity following completion of the merger. Mr. Popejoy has been one of the directors of New Century Financial since 2002, but will not continue in such capacity following completion of the merger. He has been the Managing Member of Pacific Capital Investors, an investment partnership, since 1999. Previously, he was the President and Chief Executive Officer of Financial Federation, the President of Far West Savings, the President of First Charter Financial and its subsidiary, American Savings & Loan, and the President and Chief Executive Officer of The Federal Home Loan Mortgage Corporation (Freddie Mac). In addition, Mr. Popejoy has served as a member of the board of trustees of PIMCO Funds since 1996 and served as a director of Commonwealth Energy from 2001 until 2003.

**Michael M. Sachs** is currently a director of New Century REIT and will continue in such capacity following completion of the merger. Mr. Sachs has been one of the directors of New Century Financial since 1995, but will not continue in such capacity following completion of the merger. Mr. Sachs has been Chairman of the Board and Chief Executive Officer of Westrec Financial, an operator of marinas and related businesses, since 1990. He has also served as Chairman of the Board and Chief Executive Officer of Pinpoint Systems, a manufacturer of marine electronic equipment, since December 1995.

**Terrence P. Sandvik** is currently a director of New Century REIT and will continue in such capacity following completion of the merger. Mr. Sandvik has been one of the directors of New Century Financial since 2000, but will not continue in such capacity following completion of the merger. Mr. Sandvik is currently retired. From 1990 to 1999, Mr. Sandvik was President of U.S. Bancorp Business Technology Center at U.S. Bancorp. He also served previously on our board of directors from February 1999 to April 2000 and was reappointed in September 2000.

**Richard A. Zona** is currently a director of New Century REIT and will continue in such capacity following completion of the merger. Mr. Zona has been one of the directors of New Century Financial since 2000, but will not continue in such capacity following completion of the merger. Mr. Zona has been Chairman and Chief Executive Officer of Zona Financial, a private financial advisory firm, since 2000. Previously, Mr. Zona was Vice Chairman of U.S. Bancorp, a bank holding company, from 1996 to 2000, and Chief Financial Officer of U.S. Bancorp from 1989 to 1996. He currently serves as a director of Piper Jaffray Companies, a public securities firm, ING Direct Bank, Polaris Industries, a public company that manufactures snowmobiles, all-terrain vehicles and related equipment, and Shopko Stores, a public company and retailer of goods and services.



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## Material U.S. federal income tax consequences

### INTRODUCTION

The following general discussion summarizes the material U.S. federal income tax considerations regarding our qualification and taxation as a REIT and material U.S. federal income tax consequences of an investment in our common stock. This discussion is based on interpretations of the Internal Revenue Code, regulations issued thereunder, and rulings and decisions currently in effect (or in some cases proposed), all of which are subject to change. Any such change may be applied retroactively and may adversely affect the federal income tax consequences described herein. This summary addresses only investors that beneficially own shares of our common stock as capital assets. This summary does not discuss all of the tax consequences that may be relevant to particular stockholders or to stockholders subject to special treatment under the federal income tax laws, such as:

- ∅ financial institutions or insurance companies;
  
- ∅ mutual funds;
  
- ∅ tax exempt organizations;
  
- ∅ insurance companies;
  
- ∅ dealers or brokers in securities or foreign currencies;
  
- ∅ traders in securities that elect to apply a mark to market method of accounting;
  
- ∅ foreign holders;
  
- ∅ persons that hold their shares as part of a hedge against currency risk, appreciated financial position, straddle, constructive sale or conversion transaction;
  
- ∅ holders that acquired their shares upon the exercise of stock options or otherwise as compensation; or
  
- ∅ entities treated as partnerships for U.S. federal income tax purposes.

Accordingly, stockholders are urged to consult their tax advisors with respect to the U.S. federal, state and local tax consequences of owning shares, as well as any consequences arising under the laws of any other taxing jurisdiction to which they may be subject.



O Melveny & Myers LLP has reviewed the discussion set forth below and is of the opinion that the statements made in this discussion, to the extent such statements summarize material U.S. federal tax consequences of the beneficial ownership of our common stock, are correct in all material respects. The opinion of O Melveny & Myers LLP has been filed as an exhibit to the registration statement of which this prospectus forms a part. O Melveny & Myers LLP's opinion is based on various assumptions, including that the parties to the merger agreement will take the actions contemplated by, and otherwise will satisfy their obligations under, the merger agreement, and that certain factual representations and covenants made by one of our officers are and remain accurate; moreover, the opinion is subject to limitations, and is not binding on the Internal Revenue Service or any court. The Internal Revenue Service may challenge the opinion of O Melveny & Myers LLP, and such a challenge could be successful.

We urge you to consult your own tax advisor regarding the specific tax consequences to you of ownership of shares of our common stock and of our election to be taxed as a REIT. Specifically, you should consult your own tax advisor regarding the federal, state, local, foreign, and other tax consequences of your stock ownership and our REIT election, and regarding potential changes in applicable tax laws.

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**TAXATION AS A REIT**

**General.** New Century Financial formed New Century REIT as a Maryland corporation on April 12, 2004 as a wholly-owned subsidiary. Immediately before the closing of this offering, NC Merger Sub, which is a wholly-owned subsidiary of New Century REIT, will merge with and into New Century with New Century as the surviving entity. As a result, New Century Financial will become a wholly-owned subsidiary of New Century REIT.

We will elect to be taxed as a REIT under Sections 856 through 859 of the Internal Revenue Code for our taxable year ending December 31, 2004. A REIT generally is not subject to federal income tax on the income that it distributes to stockholders if it meets the applicable REIT distribution requirements and other requirements for qualification as a REIT. We intend to be organized and to operate in such a manner as to qualify for taxation as a REIT. However, no assurance can be given that we will operate in a manner so as to qualify or remain qualified as a REIT.

We have received an opinion of O Melveny & Myers LLP, filed as an exhibit to the registration statement of which this prospectus is a part, to the effect that, commencing with our taxable year ending December 31, 2004 and assuming that the elections and other procedural steps described in this section captioned **Material U.S. federal income tax consequences** are completed by us in a timely fashion, we will be organized in conformity with, and our proposed method of operation will enable us to meet, the requirements for qualification as a REIT under the Internal Revenue Code. It must be emphasized, however, that the opinion of O Melveny & Myers LLP will be based on various assumptions related to our organization and proposed operations and will be conditioned on representations and covenants made by our management regarding our organization, assets, sources of gross income and other matters related to the conduct of our business operations. You should be aware that opinions of counsel are not binding on the Internal Revenue Service, and no assurance can be given that the Internal Revenue Service will not challenge the conclusions set forth in such opinions.

Qualification and taxation as a REIT depends upon our ability to meet on a continuing basis, through actual annual (or in some cases quarterly) operating results, various requirements under the Internal Revenue Code, with regard to, among other things, the sources of our gross income, the composition and values of our assets, our distribution levels, and the diversity of ownership of our stock. O Melveny & Myers LLP will not review our compliance with the requirements on a continuing basis. Our ability to satisfy the asset and gross income tests applicable to a REIT depends, among other things, on the fair market values of our assets and the fair market value of the real estate that is collateral for our mortgage loans. Such values may not be susceptible to a precise determination. While we intend to operate so that we will qualify as a REIT, given the highly complex nature of the rules governing REITs, the ongoing importance of factual determinations, and the possibility of future changes in circumstances, no assurance can be given by O Melveny & Myers LLP or by us that we will so qualify for any particular year. For a discussion of the tax consequences of the failure to qualify as a REIT, see **Failure to qualify**.

The sections of the Internal Revenue Code and the corresponding regulations that govern the federal income tax treatment of a REIT and its stockholders are highly technical and complex. The following discussion is qualified in its entirety by the applicable Internal Revenue Code provisions, rules and regulations promulgated thereunder, and administrative interpretations thereof.

In any year in which we qualify for taxation as a REIT, we generally will not be subject to federal corporate income taxes on that portion of our REIT taxable income that we distribute currently to our stockholders. However, our stockholders will generally be taxed on dividends that they receive at ordinary income rates unless such dividends are designated by us as capital gain dividends or qualified



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**Material U.S. federal income tax consequences**

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dividend income. This differs from non-REIT C corporations, which generally are subject to federal corporate income taxes but whose domestic noncorporate stockholders are generally taxed on dividends they receive at the 15% rate on qualified dividend income, and whose corporate stockholders generally receive the benefit of a dividends received deduction that substantially reduces the effective rate that they pay on such dividends. In general, income earned by a REIT and distributed to its stockholders will be subject to less federal income taxation than if such income were earned by a non-REIT C corporation, subjected to corporate income tax, and then distributed and taxed to stockholders.

While we are generally not subject to corporate income taxes on income that we distribute currently to our stockholders, we will be subject to federal tax as follows:

- Ø We will be taxed at regular corporate rates on any taxable income, including net capital gain, that we do not distribute to our stockholders during, or within a specified time period after, the calendar year in which the income is earned.
- Ø Under some circumstances, we may be subject to the alternative minimum tax due to our undistributed items of tax preference and alternative minimum tax adjustments.
- Ø If we have net income from the sale or other disposition of foreclosure property that is held primarily for sale to customers in the ordinary course of business, or other non-qualifying income from foreclosure property, we will be subject to tax at the highest corporate rate on this income.
- Ø Our income from prohibited transactions will be subject to a 100% tax. In general, prohibited transactions are sales or other dispositions of property, other than foreclosure property, held primarily for sale to customers in the ordinary course of business.
- Ø If we fail to satisfy either the 75% gross income test or the 95% gross income test discussed below, but nonetheless maintain our qualification as a REIT because other requirements are met, we will be subject to a tax equal to the gross income attributable to the greater of either (i) the amount by which 75% of our gross income exceeds the amount qualifying under the 75% gross income test for the taxable year or (ii) the amount by which 90% of our gross income exceeds the amount of our income qualifying under the 95% gross income test for the taxable year, multiplied in either case by a fraction intended to reflect our profitability.
- Ø We will be subject to a 4% nondeductible excise tax on the excess of the required distribution over the sum of the amounts actually distributed and amounts retained for which federal income tax was paid, if we fail to distribute during each calendar year at least the sum of:
  - Ø 85% of our REIT ordinary income for the year;
  - Ø 95% of our REIT capital gain net income for the year; and
  - Ø any undistributed taxable income from prior taxable years, over excess distributions made with respect to prior years.
- Ø We may elect to retain and pay income tax on our net capital gain. In that case, a U.S. stockholder would include its proportionate share of our undistributed capital gain (to the extent we made a timely designation of such gain to the stockholder) in its income, would be deemed to

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have paid the tax that we paid on such gain and would be allowed a credit for its proportionate share of the tax deemed to have been paid and an adjustment would be made to increase the basis of the U.S. stockholder in our stock.

- Ø We will be subject to a 100% penalty tax on certain amounts received by us (or on certain expenses deducted by a taxable REIT subsidiary) if certain arrangements between us and a taxable REIT subsidiary, as further described below, are not comparable to similar arrangements between unrelated parties.
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Ø If we own a residual interest in a real estate mortgage investment conduit, or REMIC, we will be taxable at the highest corporate rate on the portion of any excess inclusion income, or phantom taxable income, that we derive from REMIC residual interests equal to the percentage of our stock that is held by disqualified organizations. Similar rules may apply if we own all of the equity interests in a taxable mortgage pool. To the extent that we own a REMIC residual interest or a taxable mortgage pool through a taxable REIT subsidiary, we will not be subject to this tax. For a discussion of excess inclusion income, see Taxable mortgage pools and REMICs. A disqualified organization includes:

Ø the United States;

Ø any state or political subdivision of the United States;

Ø any foreign government;

Ø any international organization;

Ø any agency or instrumentality of any of the foregoing;

Ø any other tax-exempt organization, other than a farmer's cooperative described in section 521 of the Internal Revenue Code, that is exempt both from income taxation and from taxation under the unrelated business taxable income provisions of the Internal Revenue Code; and

Ø any rural electrical or telephone cooperative.

For this reason, our charter prohibits disqualified organizations from owning our shares.

Ø If we acquire any assets from a non-REIT C corporation in a carry-over basis transaction, we could be liable for specified tax liabilities inherited from that non-REIT C corporation with respect to that corporation's built-in gain in its assets. Built-in gain is the amount by which an asset's fair market value exceeds its adjusted tax basis at the time we acquire the asset. Applicable Treasury regulations, however, allow us to avoid the recognition of gain and the imposition of corporate level tax with respect to a built-in gain asset acquired in a carry-over basis transaction from a non-REIT C corporation unless and until we dispose of that built-in gain asset during the 10-year period following its acquisition, at which time we would recognize, and would be subject to tax at the highest regular corporate rate on, the built-in gain.

We will not be treated as acquiring the assets of New Century Financial or its subsidiaries in a carryover basis transaction.

In addition, notwithstanding our status as a REIT, we may also have to pay certain state and local income taxes, because not all states and localities treat REITs in the same manner that they are treated for federal income tax purposes. Moreover, as further described below, any taxable REIT subsidiary in which we own an interest, including New Century Financial and its subsidiaries, will be subject to federal corporate income tax on its taxable income.

**Requirements for qualification as a REIT.** The Internal Revenue Code defines a REIT as a corporation, trust or association:

- (1) that is managed by one or more trustees or directors;
  - (2) the beneficial ownership of which is evidenced by transferable shares, or by transferable certificates of beneficial interest;
  - (3) that would be taxable as a domestic corporation, but for Sections 856 through 859 of the Internal Revenue Code;
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**Material U.S. federal income tax consequences**

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- (4) that is neither a financial institution nor an insurance company subject to certain provisions of the Internal Revenue Code;
- (5) the beneficial ownership of which is held by 100 or more persons;
- (6) of which not more than 50% in value of the outstanding shares are owned, directly or indirectly, by five or fewer individuals (as defined in the Internal Revenue Code to include certain entities) after applying certain attribution rules;
- (7) that makes an election to be a REIT for the current taxable year or has made such an election for a previous taxable year, which has not been terminated or revoked; and
- (8) that meets other tests, described below, regarding the nature of its income and assets.

Conditions (1) through (4), inclusive, must be met during the entire taxable year. Condition (5) must be met during at least 335 days of a taxable year of 12 months, or during a proportionate part of a taxable year of less than 12 months other than the first taxable year for which an election to become a REIT is made. Condition (6) must be met during the last half of each taxable year other than the first taxable year for which an election to become a REIT is made. For purposes of determining the ownership of shares under condition (6), a supplemental unemployment compensation benefits plan, a private foundation or a portion of a trust permanently set aside or used exclusively for charitable purposes generally is considered an individual. However, a trust that is a qualified trust under Section 401(a) of the Internal Revenue Code generally is not considered an individual, and beneficiaries of a qualified trust are treated as holding shares of a REIT in proportion to their actuarial interests in the trust for purposes of condition (6). We believe that we will issue sufficient shares of stock with sufficient diversity of ownership to allow it to satisfy conditions (5) and (6) above. In addition, our charter will contain restrictions regarding the transfer of our stock that are intended to assist us in continuing to satisfy the share ownership requirements described in (5) and (6) above. These restrictions, however, may not ensure that we will be able to satisfy these share ownership requirements. If we fail to satisfy these share ownership requirements, we will fail to qualify as a REIT.

If we comply with regulatory rules pursuant to which we are required to send annual letters to holders of our stock requesting information regarding the actual ownership of our stock, and we do not know, or exercising reasonable diligence would not have known, whether we failed to meet requirement (6) above, we will be treated as having met the requirement.

In addition, we must satisfy all relevant filing and other administrative requirements established by the Internal Revenue Service that must be met to elect and maintain REIT status, use a calendar year for federal income tax purposes, and comply with the record keeping requirements of the Internal Revenue Code and regulations promulgated thereunder.

**Distribution of earnings and profits attributable to non-REIT C corporation taxable years.** To qualify as a REIT, we cannot have at the end of any taxable year any undistributed earnings and profits that are attributable to a non-REIT C corporation taxable year ( C corporation E&P ). Generally, we will not be treated as succeeding to the C corporation E&P of New Century Financial or its subsidiaries in connection with the formation transactions because we will make an election to treat New Century Financial and its subsidiaries as taxable REIT subsidiaries as of the completion of this offering.



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However, as part of the formation transactions, we expect to acquire all of the capital stock of New Century Credit which is currently an indirect wholly-owned subsidiary of New Century Financial. New Century Credit will become a qualified REIT subsidiary and we may succeed to New Century Credit s

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C corporation E&P, if any. If we succeed to such C corporation E&P, we will be required to distribute any such C corporation E&P as of the close of our first taxable year as a REIT and therefore may need to make a small special one-time distribution in an amount intended to equal or exceed such C corporation E&P. U.S. holders would generally be subject to tax on the distribution of New Century Credit's C corporation E&P at ordinary income tax rates. It appears that U.S. holders who are taxed as individuals would be taxed at a maximum rate of 35% on that distribution, rather than the 15% rate applicable to certain corporate dividends, even though that distribution would be attributable to non-REIT C corporation E&P. See Taxation of U.S. holders of our common stock. Legislation introduced in Congress would treat our distribution of C corporation E&P as eligible for the 15% rate applicable to certain corporate dividends. We can provide no assurance that such legislation will be enacted into law.

A national accounting firm will prepare an estimate of New Century Credit's C corporation E&P, based on which we will determine the amount of the special E&P distribution that we must make to purge New Century Credit's C corporation E&P, if any. However, the determination of C corporation E&P is extremely complex and the computations by our national accounting firm are not binding on the Internal Revenue Service. If the Internal Revenue Service were to successfully assert that we failed to distribute an amount equal to the inherited C corporation E&P of New Century Credit as of the close of our first taxable year as a REIT, we could fail to qualify as a REIT. Alternatively and although the law on this issue is not entirely clear, we may avoid being disqualified as a REIT for each taxable year during which we had C corporation E&P if we satisfy certain deficiency dividend procedures described in the Internal Revenue Code and the Treasury regulations thereto.

O Melveny & Myers LLP will express no opinion as to the amount of C corporation E&P. Accordingly, for its opinion as to our qualification as a REIT, O Melveny & Myers LLP will rely upon a representation from us that we will have eliminated all of its C corporation E&P as of the close of our first taxable year.

**Qualified REIT subsidiaries.** If a REIT owns a corporate subsidiary that is a qualified REIT subsidiary, the separate existence of that subsidiary is disregarded for federal income tax purposes. Generally, a qualified REIT subsidiary is a corporation, other than a taxable REIT subsidiary, all of the capital stock of which is owned by the REIT. All assets, liabilities and items of income, deduction and credit of the qualified REIT subsidiary will be treated as assets, liabilities and items of income, deduction and credit of the REIT itself. A qualified REIT subsidiary is not subject to federal corporate income taxation, although it may be subject to state and local taxation in some states.

**Other disregarded entities and partnerships.** An unincorporated domestic entity, such as a partnership or limited liability company, which has a single owner generally is not treated as an entity separate from its parent for federal income tax purposes. If we own 100% of the interests of such an entity and such entity has not elected to be treated as a corporation for U.S. federal income tax purposes, we will be treated as owning its assets and receiving its income directly. An unincorporated domestic entity with two or more owners generally is treated as a partnership for federal income tax purposes. In the case of a REIT that is a partner in a partnership that has other partners, the REIT is treated as owning its proportionate share of the assets of the partnership and as earning its proportionate share of the gross income of the partnership for purposes of the applicable REIT qualification tests. Thus, our proportionate share, based on percentage capital interests, of the assets, liabilities and items of income of any partnership, joint venture or limited liability company that is treated as a partnership for U.S. federal income tax purposes in which we acquire an interest, directly or indirectly, will be treated as our assets and gross income for purposes of applying the various REIT qualification requirements.

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**Taxable REIT subsidiaries.** A taxable REIT subsidiary is an entity that is taxable as a corporation in which we directly or indirectly own stock and that elects with us to be treated as a taxable REIT subsidiary under the Internal Revenue Code. In addition, if one of our taxable REIT subsidiaries owns, directly or indirectly, securities representing more than 35% of the vote or value of a subsidiary corporation, that subsidiary will also be treated as a taxable REIT subsidiary. However, an entity will not qualify as a taxable REIT subsidiary if it directly or indirectly operates or manages a lodging or health care facility or, generally, provides to another person, under a franchise, license or otherwise, rights to any brand name under which any lodging facility or health care facility is operated. Following the merger, we will have several direct and indirect subsidiaries, including New Century Financial, most of which we intend to elect to treat as taxable REIT subsidiaries as of the closing date of the merger. As taxable REIT subsidiaries, these entities will be subject to federal income tax, and state and local income tax where applicable, on their taxable income. To the extent that New Century Financial and its subsidiaries are required to pay taxes, they will have less cash available for distribution to us. If dividends are paid by these taxable REIT subsidiaries to us, then the dividends we pay to our stockholders who are individuals, up to the amount of dividends that we receive from our taxable REIT subsidiaries, will generally be eligible to be taxed at the reduced 15% rate applicable to qualified dividend income. See Taxation of U.S. holders of our common stock-qualified dividend income.

Income earned by a taxable REIT subsidiary is not attributable to the REIT. As a result, income that might not be qualifying income for purposes of the income tests applicable to REITs, such as fees from the origination and/or servicing of loans for third parties, could be earned by a taxable REIT subsidiary without affecting our status as a REIT. We expect to continue to sell all of our loans that we do not hold in our portfolio, and to perform other origination functions, through New Century Financial and its subsidiaries.

Several provisions of the Internal Revenue Code regarding the arrangements between a REIT and its taxable REIT subsidiaries ensure that a taxable REIT subsidiary will be subject to an appropriate level of federal income taxation. For example, a taxable REIT subsidiary is limited in its ability to deduct interest payments made to its REIT parent. We currently do not anticipate that this limitation will apply to interest payments, if any, made by taxable REIT subsidiaries to us. In addition, we would be obligated to pay a 100% penalty tax on some payments that we receive from, or on certain expenses deducted by, our taxable REIT subsidiaries if the Internal Revenue Service were to assert successfully that the economic arrangements between us and our subsidiaries are not comparable to similar arrangements among unrelated parties.

**Taxable mortgage pools and REMICs.** An entity, or a portion of an entity, that does not elect to be treated as a REMIC may be classified as a taxable mortgage pool under the Internal Revenue Code if:

- ∅ substantially all of its assets consist of debt obligations or interests in debt obligations;
- ∅ more than 50% of those debt obligations are real estate mortgages or interests in real estate mortgages as of specified testing dates;
- ∅ the entity has issued debt obligations (liabilities) that have two or more maturities; and
- ∅ the payments required to be made by the entity on its debt obligations bear a relationship to the payments to be received by the entity on the debt obligations that it holds as assets.

Under the Treasury regulations, if less than 80% of the assets of an entity (or a portion of an entity) consist of debt obligations, these debt obligations are considered not to comprise substantially all of its assets, and therefore the entity would not be treated as a taxable mortgage pool.



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We may make investments or enter into financing and securitization transactions that give rise to our being considered to be, or to own an interest in, one or more taxable mortgage pools or REMICs, although we do not intend to engage in REMIC securitization transactions other than through a taxable REIT subsidiary.

Where an entity, or a portion of an entity, is classified as a taxable mortgage pool, it is generally treated as a taxable corporation for federal income tax purposes. However, special rules apply to a REIT, a portion of a REIT, or a qualified REIT subsidiary that is a taxable mortgage pool. The portion of a REIT's assets held directly or through a qualified REIT subsidiary that is classified as a taxable mortgage pool is treated as a qualified REIT subsidiary that is not subject to corporate income tax, and the taxable mortgage pool classification does not affect the tax status of the REIT. Rather, the consequences of the taxable mortgage pool classification would generally, except as described below, be limited to the REIT's stockholders. The Treasury Department has yet to issue regulations governing the tax treatment of the stockholders of a REIT that owns an interest in a taxable mortgage pool.

A portion of our income from a REMIC residual interest or taxable mortgage pool, which might be non-cash accrued income, or phantom taxable income, could be treated as excess inclusion income. Excess inclusion income is an amount, with respect to any calendar quarter, equal to the excess, if any, of (i) income allocable to the holder of a residual interest in a REMIC or taxable mortgage pool interest during such calendar quarter over (ii) the sum of an amount for each day in the calendar quarter equal to the product of (a) the adjusted issue price of the interest at the beginning of the quarter multiplied by (b) 120% of the long term federal rate (determined on the basis of compounding at the close of each calendar quarter and properly adjusted for the length of such quarter). This non-cash or phantom income would nonetheless be subject to the distribution requirements that apply to us and could therefore adversely affect our liquidity. See Annual distribution requirements applicable to REITs. To the extent that a REMIC residual interest or taxable mortgage pool is owned through a taxable REIT subsidiary, any excess inclusion income generated by the REMIC residual interest or taxable mortgage pool will be recognized by the taxable REIT subsidiary, and we will not be subject to the distribution requirements with respect to any such amounts.

Our excess inclusion income would be allocated among our stockholders. A stockholder's share of excess inclusion income generally (i) would not be allowed to be offset by any net operating losses otherwise available to the stockholder, (ii) would be subject to tax as unrelated business taxable income in the hands of most types of stockholders that are otherwise generally exempt from federal income tax, and (iii) would result in the application of U.S. federal income tax withholding at the maximum rate (30%), without reduction for any otherwise applicable income tax treaty, to the extent allocable to most types of foreign stockholders. See Taxation of non-U.S. holders of our common stock Distributions and Taxation of tax-exempt holders. The manner in which excess inclusion income would be allocated among shares of different classes of our stock or how such income is to be reported to our stockholders is not entirely clear under current law. Tax-exempt investors, foreign investors and taxpayers with net operating losses should carefully consider the tax consequences described above and are urged to consult their tax advisors in connection with their decision to invest in our common stock.

If we were to own less than all of the equity interests in an entity that is classified as a taxable mortgage pool, the foregoing rules would not apply. Rather, the entity would be treated as a corporation for federal income tax purposes, and its taxable income would be subject to corporate income tax. In addition, this characterization could adversely affect our compliance with the REIT gross income and asset tests. We currently do not own, and currently do not intend to own, some, but less than all, of the equity interests in an entity that is or will become a taxable mortgage pool, and we intend to monitor the structure of any taxable mortgage pools in which we have an interest to ensure that they will not adversely affect our status as a REIT.

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**INCOME TESTS**

To qualify as a REIT, we must satisfy two gross income requirements, each of which is applied on an annual basis. First, at least 75% of our gross income, excluding gross income from prohibited transactions, for each taxable year generally must be derived directly or indirectly from:

- Ø rents from real property;
- Ø interest on debt secured by mortgages on real property or on interests in real property;
- Ø dividends or other distributions on, and gain from the sale of, stock in other REITs;
- Ø gain from the sale of real property or mortgage loans;
- Ø amounts, such as commitment fees, received in consideration for entering into an agreement to make a loan secured by real property, unless such amounts are determined by income and profits;
- Ø income derived from a REMIC in proportion to the real estate assets held by the REMIC, unless at least 95% of the REMIC's assets are real estate assets, in which case all of the income derived from the REMIC; and
- Ø interest or dividend income from investments in stock or debt instruments attributable to the temporary investment of new capital during the one-year period following our receipt of new capital that we raise through equity offerings or public offerings of debt obligations with at least a five-year term.

Second, at least 95% of our gross income, excluding gross income from prohibited transactions, for each taxable year must be derived from sources that qualify for purposes of the 75% gross income test, and from (i) dividends, (ii) interest, (iii) payments under certain qualifying hedging instruments and (iv) gain from the sale or disposition of stock, securities, or some hedging instruments. If less than 95% of the assets of a REMIC in which we hold an interest are real estate assets, we will be treated as receiving directly our proportionate share of the REMIC's income for purposes of the gross income tests.

Our income for purposes of these tests includes our allocable share of all income earned by any entities in which we own an interest that are partnerships or disregarded entities for income tax purposes (including qualified REIT subsidiaries), and the subsidiaries of these partnerships or disregarded entities that are partnerships or disregarded entities for income tax purposes.

The income tests described above are based on our gross income. For U.S. federal income tax purposes, we will be treated as earning interest income on all of our loans that have been securitized and with respect to which we have not made a REMIC election. Although we will have a partially offsetting interest expense with respect to the interest owed on the securities issued pursuant to these securitizations, this interest

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expense will not reduce the gross income that we are considered to recognize for purposes of the gross income tests.

Gross income from servicing loans for third parties and loan origination fees is not qualifying income for purposes of either gross income test. In addition, gross income from our sale of property that we hold primarily for sale to customers in the ordinary course of business is excluded from both the numerator and the denominator in both income tests. We will monitor the amount of our non-qualifying income and we will manage our portfolio to comply at all times with the gross income tests. The following paragraphs discuss some of the specific applications of the gross income tests to us.

**Dividends.** Our share of any dividends received from our taxable REIT subsidiaries or any other corporation in which we may own an interest will qualify for purposes of the 95% gross income test but

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not for purposes of the 75% gross income test. We expect to limit any dividends from our corporate subsidiaries to stay within the limit on nonqualifying income under the 75% gross income test.

**Interest.** The term interest, as defined for purposes of both gross income tests, generally excludes any amount that is based in whole or in part on the income or profits of any person. We do not expect that any of our mortgage loans will be based in whole or in part on the income or profits of any person.

Interest on debt secured by mortgages on real property or on interests in real property, including, for this purpose, prepayment penalties, loan assumption fees and late payment charges that are not compensation for services, generally is qualifying income for purposes of the 75% gross income test. However, if the highest principal amount of a loan outstanding during a taxable year exceeds the fair market value of the real property securing the loan as of the date we agreed to originate or acquire the loan, a portion of the interest income from such loan will not be qualifying income for purposes of the 75% gross income test but will be qualifying income for purposes of the 95% gross income test. The portion of the interest income that will not be qualifying income for purposes of the 75% gross income test will be equal to the portion of the principal amount of the loan that is not secured by real property—that is, the amount by which the loan exceeds the value of the real estate that is security for the loan.

The interest, original issue discount, and market discount income that we receive from our mortgage loans generally will be qualifying income for purposes of both gross income tests. However, as discussed above, if the fair market value of the property of the real estate securing any of our loans is less than the principal amount of the loan, a portion of the income from that loan will be qualifying income for purposes of the 95% gross income test but not the 75% gross income test. We expect that all or substantially all of our interest from our mortgage loans will be qualifying income for purposes of the 75% and 95% gross income tests.

**Fee income.** We may receive various fees in connection with the mortgage loans. The fees will be qualifying income for purposes of both the 75% and 95% gross income tests if they are received in consideration for entering into an agreement to make a loan secured by real property, and the fees are not determined by income and profits. Therefore, commitment fees will generally be qualifying income for purposes of the income tests. Other fees, such as fees received for servicing loans for third parties and origination fees, are not qualifying income for purposes of either income test. Currently, we intend that all loan origination fees will be earned through our taxable REIT subsidiaries. In this case, the income earned by such subsidiaries from these services will not be included for purposes of our gross income tests.

**Hedging transactions.** From time to time, we may enter into hedging transactions with respect to one or more of our assets or liabilities. Such hedging activities may include entering into interest rate swaps, caps, and floors, options, and futures and forward contracts. To the extent that we enter into an interest rate swap or cap contract, option, futures contract, forward rate agreement, or any similar financial instrument to hedge our indebtedness incurred or to be incurred to acquire or carry real estate assets, including mortgage loans, any periodic income or gain from the disposition of that contract attributable to the carrying or acquisition of the real estate assets should be qualifying income for purposes of the 95% gross income test, but not the 75% gross income test. To the extent that we hedge with other types of financial instruments, or to the extent that a portion of our mortgage loans is not secured by real estate assets (as described below under Asset tests) or in other situations, the income from those transactions is not likely to be treated as qualifying income for purposes of the gross income tests. We intend to structure any hedging transactions in a manner that does not jeopardize our status as a REIT.



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**Rents from real property.** We currently do not own any real property (other than a small amount of real property acquired through the foreclosure of mortgage loans). To the extent that we acquire real property or an interest therein in the future, rents we receive will generally qualify as rents from real property in satisfying the gross income requirements for a REIT described above only if several conditions are met. These conditions relate to the identity of the tenant, the computation of the rent payable, and the nature of the property leased. First, the amount of rent must not be based in whole or in part on the income or profits of any person. However, an amount received or accrued generally will not be excluded from rents from real property solely by reason of being based on a fixed percentage of percentages of receipts or sales. Second, rents received from a related party tenant will not qualify as rents from real property in satisfying the gross income tests unless the tenant is a taxable REIT subsidiary, at least 90% of the property is leased to unrelated tenants and the rent paid by the taxable REIT subsidiary is substantially comparable to the rent paid by the unrelated tenants for comparable space. A tenant is a related party tenant if the REIT, or an actual or constructive owner of 10% or more of the REIT, actually or constructively owns 10% or more of the tenant. Third, if rent attributable to personal property, leased in connection with a lease of real property, is greater than 15% of the total rent received under the lease, then the portion of rent attributable to the personal property will not qualify as rents from real property. Finally, for rents to qualify as rents from real property for purposes of the gross income tests, we are generally only allowed to provide services that are both usually or customarily rendered in connection with the rental of real property and not otherwise considered rendered to the occupant, except through a taxable REIT subsidiary or an independent contractor from which the REIT itself does not derive or receive any income.

**Prohibited transactions tax.** A REIT will incur a 100% tax on the net income derived from any sale or other disposition of property, other than foreclosure property, that the REIT holds primarily for sale to customers in the ordinary course of a trade or business. We believe that none of our portfolio assets are held-for-sale to customers and that a sale of any of our portfolio assets would not be in the ordinary course of our business. Whether a REIT holds an asset primarily for sale to customers in the ordinary course of a trade or business depends, however, on the facts and circumstances in effect from time to time, including those related to a particular asset. We cannot provide assurance that we will avoid owning property that may be characterized as property that we hold primarily for sale to customers in the ordinary course of a trade or business. After completing this offering, our taxable REIT subsidiaries will continue to sell a portion of the loans that they originate on a whole loan sale basis and any other loans the sale of which could be subject to the prohibited transactions tax. Sales of loans by our taxable REIT subsidiaries will not be subject to this 100% tax but such subsidiaries will be subject to regular corporate taxes on their net income.

We currently intend that any securitizations that we may undertake following this offering with regard to our loans will not be treated as sales for tax purposes. If we were to transfer a mortgage loan to a REMIC, this transfer would be treated as a sale for tax purposes and the sale may be subject to the prohibited transactions tax. As a result, REMICs are not a viable option for us to securitize our mortgage loans. Instead, we intend to structure our securitizations as non-REMIC collateralized mortgage obligation transactions, which will be treated as financings for tax purposes.

**Foreclosure property.** Foreclosure property is any real property, including interests in real property, and any personal property incident to such real property:

Ø that is acquired by a REIT as the result of the REIT having bid in such property at foreclosure, or having otherwise reduced such property to ownership or possession by agreement or process of law, after there was a default or default was imminent on a lease of such property or on indebtedness that such property secured;

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Ø for which the related loan was acquired by the REIT at a time when the default was not imminent or anticipated; and

Ø for which the REIT makes a proper election to treat the property as foreclosure property.

However, a REIT will not be considered to have foreclosed on a property where the REIT takes control of the property as a mortgagee-in-possession and cannot receive any profit or sustain any loss except as a creditor of the mortgagor.

Property generally ceases to be foreclosure property at the end of the third taxable year following the taxable year in which the REIT acquired the property, or longer if an extension is granted by the Secretary of the Treasury. This grace period terminates and foreclosure property ceases to be foreclosure property on the first day:

Ø on which a lease is entered into for the property that, by its terms, will give rise to income that does not qualify for purposes of the 75% gross income test, or any amount is received or accrued, directly or indirectly, pursuant to a lease entered into on or after such day that will give rise to income that does not qualify for purposes of the 75% gross income test;

Ø on which any construction takes place on the property, other than completion of a building or any other improvement, where more than 10% of the construction was completed before default became imminent; or

Ø which is more than 90 days after the day on which the REIT acquired the property and the property is used in a trade or business that is conducted by the REIT, other than through an independent contractor from whom the REIT itself does not derive or receive any income.

We will be subject to tax at the maximum corporate rate on any income from foreclosure property, other than income that otherwise would be qualifying income for purposes of the 75% gross income test, less expenses directly connected with the production of that income. However, income from foreclosure property, including gain from the sale of foreclosure property held-for-sale in the ordinary course of a trade or business, will qualify for purposes of the 75% and 95% gross income tests.

We may have the option to foreclose on mortgage loans when a borrower is in default. The foregoing rules would affect the implications of a decision by us to foreclose on a particular mortgage loan and may affect whether we will choose to foreclose with regard to a particular mortgage loan.

**Failure to satisfy income tests.** If we fail to satisfy one or both of the 75% and 95% gross income tests for any taxable year, we may nevertheless qualify as a REIT for that year if we are entitled to relief under the Internal Revenue Code. These relief provisions generally will be available if our failure to meet the tests is due to reasonable cause and not due to willful neglect, we attach a schedule of the sources of our income to our federal income tax return and any incorrect information on the schedule is not due to fraud with intent to evade tax. It is not possible, however, to state whether in all circumstances we would be entitled to the benefit of these relief provisions. For example, if we fail to satisfy the gross income tests because nonqualifying income that we intentionally recognize exceeds the limits on nonqualifying income, the Internal Revenue Service could conclude that the failure to satisfy the tests was not due to reasonable cause. If these relief provisions are inapplicable to a particular set of circumstances, we could fail to qualify as a REIT. Even if these relief provisions apply, a penalty tax would be imposed based on the amount of nonqualifying income. See Taxation as a REIT General.



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**ASSET TESTS**

At the close of each quarter of our taxable year, we must satisfy six tests relating to the nature of our assets.

Ø First, at least 75% of the value of our total assets must be represented by the following:

Ø interests in real property, including leaseholds and options to acquire real property and leaseholds;

Ø interests in mortgages on real property;

Ø stock in other REITs;

Ø cash and cash items;

Ø government securities;

Ø investments in stock or debt instruments attributable to the temporary investment of new capital during the one-year period following our receipt of new capital that we raise through equity offerings or public offerings of debt obligations with at least a five-year term; and

Ø regular or residual interests in a REMIC. However, if less than 95% of the assets of a REMIC consists of assets that are qualifying real estate-related assets under the federal income tax laws, determined as if we held such assets directly, we will be treated as holding directly our proportionate share of the assets of such REMIC.

Ø Second, not more than 25% of our total assets may be represented by securities, other than those in the 75% asset class.

Ø Third, the value of any one issuer's securities owned by us may not exceed 5% of the value of our total assets.

Ø Fourth, we may not own more than 10% of any one issuer's outstanding voting securities.

Ø Fifth, we may not own more than 10% of the total value of the outstanding securities of any one issuer, other than securities that qualify for the straight debt exception discussed below.

Ø Sixth, no more than 20% of the value of our total assets may be represented by the securities of one or more taxable REIT subsidiaries.

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For purposes of the third, fourth and fifth asset tests, the term "securities" does not include equity or debt securities of a qualified REIT subsidiary or taxable REIT subsidiary, mortgage loans that constitute real estate assets, other securities included in the 75% asset class above, or equity interests in a partnership. The term "securities," however, generally includes debt securities issued by a partnership or another REIT. However, "straight debt" securities are not treated as "securities" for purposes of the fifth asset test. "Straight debt" means a written unconditional promise to pay on demand on a specified date a sum certain in money if (i) the debt is not convertible, directly or indirectly, into stock, (ii) the interest rate and interest payment dates are not contingent on profits, the borrower's discretion, or similar factors and (iii) the issuer is either an individual or a partnership in which we own at least a 20% profit interest or the only securities of the issuer held by us are straight debt.

As discussed in "Taxation as a REIT - Other disregarded entities and partnerships," our assets for purposes of these tests include our allocable share of all assets held by any entities in which we own an interest that are partnerships or disregarded entities (including qualified REIT subsidiaries) for income tax purposes, and the subsidiaries of these partnerships or disregarded entities that are partnerships or disregarded entities for income tax purposes.

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The asset tests described above are based on our total assets. With regard to any securitizations following this offering for federal income tax purposes, we will be treated as owning both the loans we hold directly and the loans that we have securitized in non-REMIC collateralized mortgage obligation transactions. Although we will have a partially offsetting obligation with respect to the securities issued pursuant to the securitizations, these offsetting obligations will not reduce the total assets we are considered to own for purposes of the asset tests.

We believe that all or substantially all of the mortgage loans that we will be considered to own for purposes of these rules will be qualifying assets for purposes of the 75% asset test. For purposes of these rules, however, if the outstanding principal balance of a mortgage loan exceeds the fair market value of the real property securing the loan, a portion of such loan likely will not be a qualifying real estate asset under the federal income tax laws. Although the law on the matter is not entirely clear, it appears that the non-qualifying portion of that mortgage loan will be equal to the portion of the loan amount that exceeds the value of the associated real property that is security for that loan. To the extent that we own debt securities issued by other REITs or C corporations that are not secured by mortgages on real property, those debt securities will not be qualifying assets for purposes of the 75% asset test. We will monitor the status of our assets for purposes of the various asset tests and will seek to manage our portfolio to comply at all times with such tests. There can be no assurances, however, that we will be successful in this effort. In this regard, to determine our compliance with these requirements, we will need to estimate the value of the real estate securing our mortgage loans at various times. In addition, we will have to value our investment in taxable REIT subsidiaries and our other assets to ensure compliance with the 20% asset test applicable to our investment in one or more taxable REIT subsidiaries. Although we will seek to be prudent in making these estimates, there can be no assurances that the Internal Revenue Service will not disagree with these determinations, in which case we might not satisfy the asset tests and would fail to qualify as a REIT.

After initially meeting the asset tests after the close of any quarter, we will not lose our status as a REIT if we fail to satisfy the asset tests at the end of a later quarter solely by reason of changes in the relative values of our assets. If the failure to satisfy the asset tests results from the acquisition of securities or other property during a quarter, the failure can be cured by a disposition of sufficient non-qualifying assets within 30 days after the close of that quarter. We intend to maintain adequate records of the value of our assets to ensure compliance with the asset tests and to take any available action within 30 days after the close of any quarter as may be required to cure any noncompliance with the asset tests. We cannot ensure that these steps always will be successful. If we fail to cure the noncompliance with the asset tests within this 30-day period, we could fail to qualify as a REIT.

We currently believe that the loans, securities and other assets that we expect to hold will satisfy the foregoing asset test requirements. However, no independent appraisals will be obtained to support our conclusions as to the value of our assets and securities, or in many cases, the real estate collateral for the mortgage loans that we hold. Moreover, values of some assets may not be susceptible to a precise determination. As a result, there can be no assurance that the Internal Revenue Service will not contend that our interest in securities and other assets will not cause a violation of the asset tests applicable to REITs.

**ANNUAL DISTRIBUTION REQUIREMENTS APPLICABLE TO REITS**

To qualify as a REIT, we generally must distribute dividends (other than capital gain dividends) to our stockholders in an amount at least equal to:

- Ø the sum of (i) 90% of our REIT taxable income, computed without regard to the dividends paid deduction and our net capital gain, and (ii) 90% of our net income after tax, if any, from foreclosure property; minus





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Ø the excess of the sum of specified items of non-cash income (including original issue discount on our mortgage loans) over 5% of our REIT taxable income, computed without regard to the dividends paid deduction and our net capital gain.

Distributions generally must be made during the taxable year to which they relate. However, if we declare a dividend in October, November, or December of any year with a record date in one of these months and pay the dividend on or before January 31 of the following year, we will be treated as having paid the dividend on December 31 of the year in which the dividend was declared. In addition, distributions may be made in the following year if the dividends are declared before we timely file our tax return for the year and if made before the first regular dividend payment made after such declaration. To the extent that we do not distribute all of our net capital gain or we distribute at least 90%, but less than 100% of our REIT taxable income, as adjusted, we will be subject to tax on the undistributed amount at regular corporate tax rates.

Furthermore, we will incur a 4% nondeductible excise tax on the excess of the required distribution over the sum of the distributed amount if we fail to distribute during a calendar year (or, in the case of distributions with declaration and record dates falling in the last three months of the calendar year, by the end of January following such calendar year) at least the excess of the sum of (i) 85% of our REIT ordinary income for such year, (ii) 95% of our REIT capital gain net income for such year, and (iii) any undistributed taxable income from prior periods, over any excess distributions from prior years.

We may elect to retain rather than distribute all or a portion of our net capital gains and pay the tax on the gains. In that case, we may elect to have our stockholders include their proportionate share of the undistributed net capital gains in income as long-term capital gains and receive a credit for their share of the tax paid by us. For purposes of the 4% nondeductible excise tax described above, any retained amounts for which we elect this treatment would be treated as having been distributed.

We intend to make timely distributions sufficient to satisfy the distribution requirements. It is possible that, from time to time, we may not have sufficient cash to meet the distribution requirements due to timing differences between (i) the actual receipt of cash, including the receipt of distributions from subsidiaries, and (ii) the inclusion of items of income by us for federal income tax purposes. Possible examples of those timing differences include the following:

- Ø Because we may deduct capital losses only to the extent of our capital gains, we may have taxable income that exceeds our economic income.
- Ø We may recognize phantom taxable income from any retained ownership interests in mortgage loans subject to collateralized mortgage obligation debt that we own.
- Ø We will recognize taxable income in advance of the related cash flow if any of our mortgage loans are deemed to have original issue discount. We generally must accrue original issue discount based on a constant yield method that takes into account projected prepayments but that defers taking into account credit losses until they are actually incurred.
- Ø We may recognize taxable market discount income when we receive the proceeds from the disposition of, or principal payments on, loans that have a stated redemption price at maturity that is greater than our tax basis in those loans, although such proceeds often will be used to make non-deductible principal payments on related borrowings.

Ø We may recognize taxable income without receiving a corresponding cash distribution if we foreclose on or make a significant modification to a loan, to the extent that the fair market value of the underlying property or the principal amount of the modified loan, as applicable, exceeds our basis in the original loan.

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Ø Although several types of non-cash income are excluded in determining the annual distribution requirement, we may incur corporate income tax and a 4% nondeductible excise tax with respect to those non-cash income items if we do not distribute those items on a current basis.

As a result of the foregoing, we may have less cash than is necessary to distribute all of our taxable income and thereby avoid corporate income tax and the excise tax imposed on certain undistributed income. In such a situation, we may need to borrow funds or issue additional common or preferred stock.

Under some circumstances, we may be able to rectify a failure to meet the distribution requirement for a year by paying deficiency dividends to stockholders in a later year, which may be included in our deduction for dividends paid for the earlier year. Thus, we may be able to avoid being taxed on amounts distributed as deficiency dividends. However, we will be required to pay interest based upon the amount of any deduction taken for deficiency dividends.

### **RECORD KEEPING REQUIREMENTS**

We are required to comply with applicable record keeping requirements. Failure to comply could result in monetary fines. For example, we must request on an annual basis information from our stockholders designed to disclose the actual ownership of our outstanding common stock.

### **FAILURE TO QUALIFY**

If we fail to qualify for taxation as a REIT in any taxable year and the relief provisions do not apply, we will be subject to tax, including any applicable alternative minimum tax, on our taxable income at regular corporate rates. This would significantly reduce both our cash available for distribution to our stockholders and our earnings. If we fail to qualify as a REIT, we will not be required to make any distributions to stockholders and any distributions that are made will not be deductible. Moreover, all distributions to stockholders would be taxable as dividends to the extent of our current and accumulated earnings and profits, whether or not attributable to our capital gains. Subject to certain limitations of the Internal Revenue Code, corporate distributees may be eligible for the dividends received deduction with respect to those distributions, and domestic noncorporate distributees may be eligible for the reduced income tax rate of 15% on such dividends. Unless we are entitled to relief under specific statutory provisions, we also will be disqualified from taxation as a REIT for the four taxable years following the year during which qualification was lost. We cannot state whether in all circumstances we would be entitled to this statutory relief.

### **TAXATION OF U.S. HOLDERS OF OUR COMMON STOCK**

**U.S. holder.** As used in the remainder of this discussion, the term "U.S. holder" means a beneficial owner of our common stock that is for U.S. federal income tax purposes:

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- Ø a citizen or resident alien individual, as defined in Section 7701(b) of the Internal Revenue Code, of the United States;
  
  - Ø a corporation or other entity treated as a corporation for federal income tax purposes, created or organized in or under the laws of the United States or any state or the District of Columbia;
  
  - Ø an estate the income of which is subject to U.S. federal income taxation regardless of its source; or
  
  - Ø in general, a trust subject to the primary supervision of a U.S. court and the control of one or more U.S. persons or the trust was in existence on August 20, 1996 and has made a valid election to be treated as a U.S. person.
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**Material U.S. federal income tax consequences**

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Generally, in the case of a partnership that holds our common stock, any partner that would be a U.S. holder if it held such common stock directly is also a U.S. holder.

**Distributions generally.** As long as we qualify as a REIT, distributions made to taxable U.S. holders of our common stock out of current or accumulated earnings and profits that are not designated as capital gain dividends or qualified dividend income will be taken into account by them as ordinary income taxable at ordinary income tax rates and will not qualify for the maximum 15% rate that generally applies to distributions by non-REIT C corporations to stockholders who are taxed as individuals. In determining the extent to which a distribution constitutes a dividend for tax purposes, our earnings and profits will be allocated first to distributions with respect to our preferred stock, if any, and then to our common stock. Corporate stockholders will not be eligible for the dividends received deduction with respect to these distributions.

Distributions in excess of both our current and accumulated earnings and profits will not be taxable to a U.S. holder to the extent that the distributions do not exceed the adjusted basis of the holder's stock. Rather, such distributions will reduce the adjusted basis of the stock. To the extent that distributions exceed the adjusted basis of a U.S. holder's stock, the distributions will be taxable as capital gains, assuming the stock is held as a capital asset in the hands of the U.S. holder.

Distributions will generally be taxable, if at all, in the year of the distribution. However, if we declare a dividend in October, November, or December of any year with a record date in one of these months and pay the dividend on or before January 31 of the following year, we will be treated as having paid the dividend, and the stockholder will be treated as having received the dividend, on December 31 of the year in which the dividend was declared.

**Capital gain dividends.** We may elect to designate distributions of our net capital gain as capital gain dividends. Capital gain dividends are taxed to U.S. holders as gain from the sale or exchange of a capital asset held for more than one year. This tax treatment applies regardless of the period during which the stockholders have held their stock. If we designate any portion of a dividend as a capital gain dividend, the amount that will be taxable to the stockholder as capital gain will be indicated to U.S. holders on Internal Revenue Service Form 1099-DIV. Corporate stockholders, however, may be required to treat up to 20% of capital gain dividends as ordinary income.

Instead of paying capital gain dividends, we may elect to require stockholders to include our undistributed net capital gains in their income. If we make such an election, U.S. holders (i) will include in their income as long-term capital gains their proportionate share of such undistributed capital gains and (ii) will be deemed to have paid their proportionate share of the tax paid by us on such undistributed capital gains and thereby receive a credit or refund for such amount. A U.S. holder will increase the basis in its stock by the difference between the amount of capital gain included in its income and the amount of tax it is deemed to have paid. Our earnings and profits will be adjusted appropriately.

We must classify portions of our designated capital gain dividend into the following categories:

Ø a 15% gain distribution, which would be taxable to non-corporate U.S. holders at a maximum rate of 15%; or

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Ø an unrecaptured Section 1250 gain distribution, which would be taxable to non-corporate U.S. holders of our stock at a maximum rate of 25%.

Recipients of capital gain dividends that are taxed at corporate income tax rates will be taxed at the normal corporate income tax rates on those dividends.

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**Qualified dividend income.** Dividends paid to a U.S. holder generally will not qualify for the new 15% tax rate for qualified dividend income. The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the maximum tax rate for qualified dividend income from 38.6% to 15% for tax years 2003 through 2008. Without future congressional action, the maximum tax rate on qualified dividend income will move to 35% in 2009 and 39.6% in 2011. Qualified dividend income generally includes dividends paid by domestic C corporations and certain qualified foreign corporations to most U.S. noncorporate stockholders. Because we are not generally subject to federal income tax on the portion of our taxable income distributed to our stockholders, dividends generally will not be eligible for the new 15% rate on qualified dividend income. As a result, ordinary REIT dividends from us will continue to be taxed at the higher tax rate applicable to ordinary income. Currently, the highest marginal individual income tax rate on ordinary income is 35%. However, the 15% tax rate for qualified dividend income will apply to ordinary REIT dividends from us, if any, that are (i) attributable to dividends received by us from non-REIT corporations, such as its taxable REIT subsidiaries, or (ii) attributable to income upon which we have paid corporate income tax (e.g., to the extent that we distribute less than 100% of its taxable income). In general, to qualify for the reduced tax rate on qualified dividend income, a stockholder must hold our common stock for more than 60 days during the 120-day period beginning on the date that is 60 days before the date on which the common stock becomes ex-dividend.

**Other tax considerations.** Distributions made by us and gain arising from the sale or exchange by a U.S. holder of our stock will not be treated as passive activity income, and as a result, U.S. holders generally will not be able to apply any passive losses against this income or gain. In addition, taxable distributions from us generally will be treated as investment income for purposes of the investment interest limitations. A non-corporate U.S. holder of our stock may elect to treat capital gain dividends, capital gains from the disposition of stock and income designated as qualified dividend income as investment income for purposes of the investment interest limitation, in which case the applicable gains will be taxed at ordinary income tax rates. U.S. holders may not include in their individual income tax returns any of our net operating losses or capital losses. We would carryover our operating or capital losses for potential offset against future income, subject to applicable limitations.

We may recognize taxable income in excess of our economic income, known as phantom income, in the first years that we hold certain investments, and experience an offsetting excess of economic income over our taxable income in later years. As a result, U.S. holders at times may be required to pay federal income tax on distributions that economically represent a return of capital rather than a dividend. These distributions would be offset in later years by distributions representing economic income that would be treated as returns of capital for federal income tax purposes.

Any excess inclusion income that we recognize generally will be allocated among our stockholders to the extent it exceeds our undistributed REIT taxable income in a particular year. A U.S. holder's share of excess inclusion income would not be offset by any net operating losses of the U.S. holder that would otherwise be available. See "Taxation as a REIT Taxable mortgage pools and REMICs."

**Sales of common stock.** Upon any taxable sale or other disposition of our common stock, a U.S. holder will recognize gain or loss for federal income tax purposes on the disposition in an amount equal to the difference between:

- ∅ the amount of cash and the fair market value of any property received on such disposition; and
- ∅ the U.S. holder's adjusted basis in such common stock for tax purposes.



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Gain or loss will be capital gain or loss if the common stock has been held by the U.S. holder as a capital asset. The applicable tax rate will depend on the holder's holding period in the asset (generally, if an asset has been held for more than one year it will produce long-term capital gain) and the holder's tax

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bracket. A U.S. holder who is an individual or an estate or trust and who has long-term capital gain or loss will be subject to a maximum capital gain rate of 15%. The Internal Revenue Service has the authority to prescribe, but has not yet prescribed, regulations that would apply a capital gain tax rate of 25% (which is generally higher than the long-term capital gain tax rates for non-corporate holders) to a portion of capital gain realized by a non-corporate holder on the sale of REIT common stock that would correspond to the REIT's unrecaptured Section 1250 gain. We do not expect any material amount of such unrecaptured Section 1250 gain. Holders are advised to consult with their own tax advisors with respect to their capital gain tax liability. A corporate U.S. holder will be subject to tax at a maximum rate of 35% on capital gain from the sale of our stock.

In general, any loss upon a sale or exchange of our common stock by a U.S. holder who has held such stock for six months or less (after applying certain holding period rules) will be treated as a long-term capital loss, but only to the extent of distributions received by such U.S. holder that are required to be treated by such U.S. holder as long-term capital gains.

**TAXATION OF NON-U.S. HOLDERS OF OUR COMMON STOCK**

**Non-U.S. holder.** A non-U.S. holder is a holder, including any partner in a partnership that holds our common stock, that is not a U.S. holder. See Taxation of U.S. holders of our common stock U.S. holder.

**Distributions.** Distributions by us to a non-U.S. holder of common stock that are neither attributable to gain from sales or exchanges by us of U.S. real property interests nor designated by us as capital gains dividends will be treated as dividends of ordinary income to the extent that they are made out of our current or accumulated earnings and profits. These distributions, including the special one-time distribution, if any, declared in 2004 ordinarily will be subject to U.S. federal income tax on a gross basis at a rate of 30%, or a lower rate as permitted under an applicable income tax treaty, unless the dividends are treated as effectively connected with the conduct by the non-U.S. holder of a U.S. trade or business. Under some treaties, however, lower rates generally applicable to dividends do not apply to dividends from REITs. Further, reduced treaty rates are not available to the extent that the income allocated to the foreign stockholder is excess inclusion income. Excess inclusion income will generally be allocated to stockholders to the extent we have excess inclusion income that exceeds our undistributed REIT taxable income in a particular year. See Taxation as a REIT Taxable mortgage pools and REMICs. Dividends that are effectively connected with a trade or business will be subject to tax on a net basis, that is, after allowance for deductions, at graduated rates, in the same manner as U.S. holders are taxed with respect to these dividends, and are generally not subject to withholding. Applicable certification and disclosure requirements must be satisfied to be exempt from withholding under the effectively connected income exception. Any dividends received by a corporate non-U.S. holder that is engaged in a U.S. trade or business also may be subject to an additional branch profits tax at a 30% rate, or lower applicable treaty rate. We expect to withhold U.S. income tax at the rate of 30% on any dividend distributions not designated as (or deemed to be) capital gain dividends made to a non-U.S. holder unless:

- Ø a lower treaty rate applies and the non-U.S. holder files an Internal Revenue Service Form W-8BEN evidencing eligibility for that reduced rate; or
- Ø the non-U.S. holder files an Internal Revenue Service Form W-8ECI claiming that the distribution is income effectively connected with the non-U.S. holder's trade or business.

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Distributions in excess of our current or accumulated earnings and profits that do not exceed the adjusted basis of the non-U.S. holder in our common stock will reduce the non-U.S. holder's adjusted basis in our common stock and will not be subject to U.S. federal income tax. Distributions in excess of our current and

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accumulated earnings and profits that do exceed the adjusted basis of the non-U.S. holder in our common stock will be treated as gain from the sale of our stock, the tax treatment of which is described below. See **Taxation of non-U.S. holders of our common stock** **Sales of common stock**.

We may be required to withhold at least 10% of any distribution in excess of our current and accumulated earnings and profits, even if a lower treaty rate applies or the non-U.S. holder is not liable for tax on the receipt of that distribution. However, a non-U.S. holder may seek a refund of these amounts from the Internal Revenue Service if the non-U.S. holder's U.S. tax liability with respect to the distribution is less than the amount withheld.

Distributions to a non-U.S. holder that are designated by us at the time of the distribution as capital gain dividends, other than those arising from the disposition of a U.S. real property interest, generally should not be subject to U.S. federal income taxation unless:

- ∅ the investment in the common stock is effectively connected with the non-U.S. holder's trade or business, in which case the non-U.S. holder will be subject to the same treatment as U.S. holders with respect to any gain, except that a holder that is a foreign corporation also may be subject to the 30% branch profits tax, as discussed above; or
- ∅ the non-U.S. holder is a nonresident alien individual who is present in the U.S. for 183 days or more during the taxable year and has a tax home in the U.S., in which case the nonresident alien individual will be subject to a 30% tax on the individual's capital gains.

Under the Foreign Investment in Real Property Tax Act, which is referred to as FIRPTA, distributions to a non-U.S. holder that are attributable to gain from sales or exchanges by us of U.S. real property interests, whether or not designated as a capital gain dividend, will cause the non-U.S. holder to be treated as recognizing gain that is income effectively connected with a U.S. trade or business. Non-U.S. holders will be taxed on this gain at the same rates applicable to U.S. holders, subject to a special alternative minimum tax in the case of nonresident alien individuals. Also, this gain may be subject to a 30% (or lower applicable treaty rate) branch profits tax in the hands of a non-U.S. holder that is a corporation. We generally do not expect to pay dividends that are subject to FIRPTA.

We will be required to withhold and remit to the Internal Revenue Service 35% of any distributions to non-U.S. holders that are designated as capital gain dividends, or, if greater, 35% of a distribution that could have been designated as a capital gain dividend, whether or not attributable to sales of U.S. real property interests. Distributions can be designated as capital gains to the extent of our net capital gain for the taxable year of the distribution. The amount withheld, which for individual non-U.S. holders may exceed the actual tax liability, is creditable against the non-U.S. holder's U.S. federal income tax liability.

**Sales of common stock.** Gain recognized by a non-U.S. holder upon the sale or exchange of our stock generally would not be subject to U.S. taxation unless:

- ∅ the investment in common stock is effectively connected with the non-U.S. holder's U.S. trade or business, in which case the non-U.S. holder will be subject to the same treatment as U.S. holders with respect to any gain;

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- Ø the non-U.S. holder is a nonresident alien individual who is present in the United States for 183 days or more during the taxable year and has a tax home in the United States, in which case the nonresident alien individual will be subject to a 30% tax on the individual's net capital gains for the taxable year; or
  
  - Ø the common stock constitutes a U.S. real property interest within the meaning of FIRPTA, as described below.
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Our common stock will not constitute a U.S. real property interest if we either are not a U.S. real property holding corporation or are a domestically-controlled REIT. Whether we are a U.S. real property holding corporation will depend upon whether the fair market value of U.S. real property interests owned by us equals or exceeds 50% of the fair market value of our assets. Because our assets will consist primarily of single-family residential mortgage loans, we do not expect that our assets will cause us to be considered a U.S. real property holding corporation. We will be a domestically-controlled REIT if, at all times during a specified testing period, less than 50% in value of our stock is held directly or indirectly by non-U.S. holders. We expect to qualify as a domestically-controlled REIT upon completion of the merger but cannot guarantee that we will remain a domestically-controlled REIT.

In addition, even if we are a U.S. real property holding corporation and do not qualify as a domestically-controlled REIT at the time a non-U.S. holder sells its stock, the gain from such a sale by such a non-U.S. holder will not be subject to FIRPTA tax if:

- Ø the class or series of stock sold is considered regularly traded under applicable Treasury regulations on an established securities market, such as the NYSE; and